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Special Reports: Application of statement on auditing procedure no. 28

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Special Reports

**Application of Statement on
Auditing Procedure No. 28**

**AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS
270 Madison Avenue, New York 16, New York**

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Auditing Procedure No. 28**

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CONTENTS

PREFACE	5
INTRODUCTION	7
Application of Generally Accepted Auditing Standards	8

Section I

CASH OR OTHER INCOMPLETE ACCOUNTING BASES ..	9
Cash Basis Statements — General	11
Sole Proprietorships	17
Partnerships	21
Personal Accounts	24
Estates, Trusts, and Guardianships	26
Farms	29
Churches, Community Funds, and Other Religious, Charitable, or Cultural Organizations	32
Clubs	37

Section II

NONPROFIT ORGANIZATIONS WHICH FOLLOW SPECIAL ACCOUNTING PRACTICES	41
Colleges and Universities	42
Municipalities	49
Hospitals	55

Section III

REPORTS ON CERTAIN ASPECTS OF FINANCIAL STATEMENTS	61
Reports Relating to Compliance with Provisions Contained in Bond Indentures and Various Loan Agreements	62
Letters for Information of Underwriters in Connection with SEC Registrations	66
Other Instances	73
Royalty Agreements	73
Pension and Profit-Sharing Plans	75
Lease Agreements	80
Sinking Fund Contributions	81
Income Available for Dividends	82
Report on Contract Guarantees	83

Section IV

PREScribed FORM REPORTS	85
Securities Brokers and Dealers	86
Highway Contractors' Prequalification Reports	89
Massachusetts Certificate of Condition	94
New York State Welfare Department Annual Report on Charitable Organizations	96
United States Department of Labor Reports	97

APPENDIX — Complete text of Statement on Auditing Procedure No. 28	101
---	-----

INDEX	109
-------------	-----

Preface

In some ways this is a "how to do it" booklet. Its purpose is to illustrate the application of the reporting standards set forth in Statement on Auditing Procedure No. 28, *Special Reports (Applicability of Reporting Standards in Special Circumstances)*, issued by the committee on auditing procedure of the American Institute of Certified Public Accountants in October 1957.

The term "special reports" is used to designate reports prepared in circumstances where the language of the standard short-form auditor's report or certificate may not be appropriate because of special reporting problems arising from the characteristics of the financial statements presented, or because of special purposes for which the report has been prepared. This booklet discusses the special features involved in each of a number of different types of situations and suggests ways of handling them in the auditor's report. In general, the booklet is directed specifically to the short-form report. When generally accepted auditing standards have been followed it is generally sufficient in a short-form report to say so and to avoid reference to any specific procedures followed, for such reference might be construed to constitute an exception. If specific procedures are referred to, it is preferable to place them after the opinion, as is usually done in a long-form report.

The examples presented in this booklet were taken from actual cases (with identification removed) adapted to conform with Statement No. 28. It should be emphasized that they do not reflect the only language that would comply with Statement No. 28. They are presented to suggest language that would generally be appropriate but they should not be used without careful consideration of their appropriateness in each particular case. The opinions expressed herein are solely those of the Technical Services Department; the committee on auditing procedure has expressed neither approval nor disapproval of them.

CARMAN G. BLOUGH, *Director of Research*
American Institute of Certified Public Accountants

Introduction

Much time and effort has gone into the development and application of auditing standards to improve reports on financial statements of commercial and industrial corporate enterprises.

These reports, while important in content and in the number of people whom they affect, are only a part of those which the practicing certified public accountant must regularly prepare. Many other reports deal with accounts kept on a cash or modified cash basis, or in accordance with accounting procedures devised, or generally followed, by accounting groups within special fields. Some deal with nonprofit enterprises, partnerships, sole proprietorships, estates and personal accounts. Others are prepared on printed forms or may relate only to certain accounts, to compliance with agreements, or to a wide variety of other matters.

Heretofore, the practicing certified public accountant has had little to guide him in preparing many of these reports. The committee on auditing procedure of the American Institute of Certified Public Accountants has now made available, by the publication of Statement on Auditing Procedure No. 28, *Special Reports (Applicability of Reporting Standards in Special Circumstances)*, an authoritative statement clarifying, in general terms, the application of generally accepted auditing standards to reports on engagements of this kind.

This booklet is directed to the application of those standards in specific situations. It is divided into sections which contain not only a discussion of the more important features of various types of special reporting circumstances, and their effect on the reporting, but also a number of examples illustrative of ways of handling some of the more difficult of these problems. It cannot, of course, envision every situation which may arise in practice, but it does attempt to cover the more usual ones and, thereby, to suggest possible solutions for other situations. It is not the intent of this booklet to establish "standard" language for these reports. As a matter of fact, several examples of

possible language are presented in most of the sections. It is hoped that these examples will provide a useful guide to the practicing certified public accountant in his preparation of "special" reports.

For convenience, the complete text of Statement on Auditing Procedure No. 28 is furnished as an appendix to this booklet.

Application of Generally Accepted Auditing Standards

Paragraph 6 of Statement on Auditing Procedure No. 28 summarizes the auditing standards as follows:

Generally Accepted Auditing Standards characterizes the term generally accepted auditing standards as used in auditors' reports on financial statements in such a way as to include (a) general standards, (b) standards of field work, and (c) standards of reporting. It is the opinion of the committee that, to the extent appropriate in view of the character of the engagement, the substance of the general standards and of the standards of field work applies to engagements involving special reports.

In view of the foregoing pronouncement that the *substance of the general standards and standards of field work applies in all special report engagements to the extent appropriate*, it is the application of the standards of reporting that requires clarification and illustration.

To facilitate the discussion of the application of reporting standards the four general types of special reporting circumstances, as summarized in Statement on Auditing Procedure No. 28, will be used as a basic outline.

SECTION I

Cash or Other Incomplete Accounting Bases

This type of special report includes the following, as noted in Paragraph 3a of Statement No. 28:

Reports on financial statements of organizations which maintain their accounts and prepare their statements on a cash or other incomplete basis of accounting which is materially at variance with accounting practices customarily followed in preparing accrual basis statements. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some nonprofit organizations.

The application of the four reporting standards to the above special report circumstances is outlined in the following paragraphs of the Statement:

1. An opinion as to conformity of financial statements with generally accepted principles of accounting (Paragraphs 8, 9 and 10):

8. Although there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations, such as in reports upon compliance with certain provisions of bond indentures, the committee is of the opinion that the requirement of the first standard of reporting does not apply to statements which do not purport to set forth financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In re-

porting on statements which do not so purport the auditor should make sure that it is clearly stated what they do purport to present and the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. The committee believes it to be generally preferable in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements; notwithstanding this preference, the committee recognizes the long-established acceptance of these terms and accordingly feels that it should not, at this time, do more than express its preference.

9. In reporting on statements prepared on a cash basis (or substantially so) which nevertheless may appear to present financial position and results of operations, disclosure should ordinarily be made in the statements or their footnotes or, less preferably, in the auditor's report, (a) of the fact that the statements have been prepared on the basis of cash receipts and disbursements and (b) of the general nature of any material items omitted (such as accounts receivable and accounts payable) and, where practicable, of the net effect of such omissions on the statements. The auditor's opinion might then be worded somewhat as follows:

"In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19____, arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year."

Notwithstanding the foregoing, where the auditor thinks that misleading inferences may still be drawn from the statements, he should include an explanation in his report that the statements do not present financial position and results of operations.

10. In reporting on statements prepared on a modified accrual basis of accounting, which nevertheless usually purport to present financial position and results of operations, the auditor may consider the resulting statements to be materially incomplete or to have been prepared in accordance with accounting practices materially at variance with those customarily followed in preparing accrual basis statements. In such cases it is desirable to disclose the nature and amounts of the major items involved and, in his report, to state an exception or explain clearly why he is unable to express the usual opinion on the fairness of presentation of financial position and results of operations.

2. An opinion as to consistency with which these principles have been observed (Paragraph 12):

12. When the report relates to statements which purport to present financial position or results of operations, the second standard of reporting as to consistency in the application of generally accepted ac-

counting principles is, of course, applicable. When the report relates to other matters, reference to consistency is frequently appropriate, depending upon the nature of the matter reported upon.

3. Adequate informative disclosures (Paragraph 13):

13. As to the third standard of reporting, adequate informative disclosures are, of course, required at all times. Where the auditor considers the basis on which the financial statements have been prepared to be inappropriate or unsuitable in the circumstances, appropriate disclosures should be made.

4. An expression of opinion regarding the financial statements taken as a whole, or a statement to the effect that an opinion cannot be expressed, together with the reasons therefor, and, in all cases, a clear-cut indication of the character of the auditor's examination, if any, and of the degree of responsibility he is taking (Paragraph 14):

14. The fourth standard of reporting requires that the report shall contain either an expression of opinion or an assertion to the effect that an opinion cannot be expressed and the reasons therefor. This standard also requires that the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking. At the time this standard was adopted the major concern was with statements purporting to show financial position or results of operations. The requirements of this auditing standard, however, are, in the committee's opinion, applicable to special reports.

Cash Basis Statements — General

Cash basis statements ordinarily do not purport to present either the financial position of an enterprise at a given date or the results of its operation for a given period of time. A statement of assets and liabilities on a cash basis (reflecting, as it frequently does, only assets and liabilities resulting directly from cash transactions and sometimes not even that) is not, except by coincidence, an adequate statement of financial position. A statement of revenues collected and expenses paid is not, in most instances, the equivalent of a statement of income or of operating results and should not be construed as such.

In reporting on these statements special care should be taken to avoid misleading inferences. The wording used to describe cash basis statements should indicate clearly what the statements do represent and should avoid implications that the statements purport to present financial position, operating results, or anything beyond that which they should be expected to cover.

Footnotes Disclosing Omissions. Ordinarily, cash basis statements cannot be made to present financial position or operating results by adding footnotes which disclose the information necessary to convert them to the accrual basis, although such footnotes may impart useful information. Footnotes will not make an otherwise unacceptable statement acceptable since they lay upon the reader the burden of making revisions and adjustments requiring technical skill, knowledge and an informed judgment not presumptively attributable to the user of financial statements. An example of possible wording of such a footnote which might be appropriate in certain circumstances follows:

It is the practice of the company to maintain its accounts on a cash basis and, accordingly, the statements do not reflect accounts receivable balances totaling \$_____ at July 31, 19__ or inventories, which at that date were approximately \$_____ at the lower of cost or market.

In cases where it is not feasible to determine or reasonably estimate amounts, this note may be modified along the following lines: “. . . or inventories the amount of which were not determined by the company and are not susceptible of reasonable estimate, etc.”

Reference to Generally Accepted Accounting Principles. Cash basis statements merely summarize cash transactions. It is the fairness with which they present the cash transactions, rather than the inclusion of all pertinent information based on generally accepted accounting principles, which has significance. Reference to generally accepted accounting principles in an opinion relating to such statements is inappropriate, except, of course, where the amounts omitted are not material, in which case the statements may be said to present fairly the financial position and results of operations.

Uses and Limitations of Cash Basis Statements. Assuming that they are so designed as to adequately accomplish the results sought, cash basis statements are useful and appropriate in many circumstances and should not be disparaged because they are not something usually expected. But in view of the complexities of modern business, public and private, it seems hardly possible that they could be adequate where the results sought include a fair presentation of financial position and operating results.

They may be appropriate where operations consist wholly or principally of the receipt and disbursement of cash. Charitable agencies, civic associations, and social or religious groups find them useful, for

to them the important information is the availability and disposition of cash for the purposes for which the activity is conducted. They are useful also as a means of projecting future cash requirements generally. They often serve as aids to owners or managers of professional firms or of agricultural or other business enterprises to whom the amounts of inventories on hand or of receivables and payables outstanding at a given date (as well as the rise and fall in these amounts in a given period) are either immaterial or well known without reference to the statements.

Statements are sometimes prepared from cash basis accounts adjusted to include one or more items on the accrual basis, as for example statements which include the inventory of stock on hand but do not include receivables or payables for goods or services or accruals of income or expenses. Such statements usually appear to present financial position but fail to do so fairly so long as known assets, liabilities, income, or expenses (if material in amount) are not included. In such cases, if the independent auditor believes misleading inferences may be drawn from the statements, he should report that they do not present financial position and results of operations. Accordingly, cash basis statements should be clearly described for what they are. In his report the independent certified public accountant should state clearly what the statements purport to present and should express or disclaim an opinion as to whether or not they do so.

Many clients cling to the cash basis or a hybrid basis for tax considerations. Often the information necessary for a fair presentation on an accrual basis is available and there is generally no reason why, for statement purposes, the adjustments to convert to an appropriate accrual basis should not be made. The independent auditor should persuade his client to do this whenever possible in order that an opinion on fair presentation of financial position and results of operations may be given.

Descriptive Titles of Cash Basis Statements. Titles should describe the statements accurately and in enough detail to prevent misleading inferences as to what the statements present. No standard wording can be devised in view of the variety of circumstances in which cash basis statements are issued. The following are examples of wording suitable under the conditions which they express:

Statement of assets and liabilities resulting from cash transactions

Statement of cash revenues collected and expenses paid

Statement of assets and liabilities arising from cash receipts and disbursements

Statement of cash receipts and disbursements on account of income and expenses

Statement of assets and liabilities on a cash basis

Statement of income (cash basis)

Statement of assets and liabilities on a cash basis, adjusted to give effect to inventory of stock on hand

Statement of cash receipts and disbursements on account of income and expenses, adjusted to give effect to inventories of stock on hand at the beginning and end of the period

Statement of assets and liabilities on a cash basis, adjusted as stated in Note 1

Statement of cash receipts and disbursements on account of income and expenses, adjusted as stated in Note 1

(Note describes adjustments made to give effect to inventory of stock on hand at beginning and end of period.)

Statement of cash receipts and disbursements

Statement of cash collections of revenues and disbursements of expenses

Examples of Reports:

1. Report relating to examination of a statement of cash receipts and disbursements:

We have examined the statement of cash receipts and disbursements of Children's Center of _____ for the year ended June 30, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement of cash receipts and disbursements presents fairly the cash transactions of Children's Center of _____ for the year ended June 30, 19____.

2. Report relating to examination of cash basis statements of a non-profit society:

We have examined the accompanying statement of assets and liabilities, resulting from cash transactions, of _____ Society

as of December 31, 19____, and the related statement of cash receipts and disbursements on account of income and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records, and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statements present fairly the assets and liabilities of _____ Society at December 31, 19____ resulting from cash transactions, and the income collected and expenses disbursed during the year then ended, on a basis consistent with that of the preceding year.

3. Report relating to cash basis accounts, the accruals being negligible (a preferable alternative to the disclosure in the second paragraph is a note to the financial statements and the use of the standard short-form report):

We have examined the balance sheet of the _____ Association, Inc., as of March 31, 19____, and the statement of income and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Although the accounts are maintained on a cash basis, the differences between such basis and the accrual basis are relatively immaterial.

In our opinion, the accompanying balance sheet and statement of income and expenses present fairly the financial position of the _____ Association, Inc., at March 31, 19____, and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

4. Report on examination of statements of cash receipts and disbursements and of securities owned:

We have examined the statement of cash receipts and disbursements of Community Fund of _____, Inc. (a [state] non-profit corporation) for the year ended December 31, 19____, and the statement of securities owned at December 31, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting

records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement presents fairly the cash receipts and disbursements of Community Fund of _____, Inc., for the year ended December 31, 19____, and securities owned by the fund at December 31, 19____.

5. Report relating to a partnership which is on a cash basis except that it takes up inventories of stock on hand (report contains disclaimer as to presentation of financial position and operating results). (See also examples 1 and 2 under sole proprietorship):

We have examined the following statements of X and Y (a partnership) as of December 31, 19____ and for the year then ended:

Statement of assets and liabilities, on a cash basis, adjusted to give effect to inventory of stock on hand.

Statement of cash receipts and disbursements on account of income and expenses, adjusted to give effect to inventories of stock on hand at the beginning and end of the year.

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Because such assets and liabilities as trade accounts receivable and payable, accrued wages, rent and interest, and other accrued income and expenses, which are material in amount, are not included, the statements do not, in our opinion, present financial position or the results of operations.

However, in our opinion, these statements do present fairly the assets and liabilities of the partnership of X and Y as of December 31, 19____, arising from cash transactions, and partnership income collected and expenses disbursed for the year then ended, both as adjusted to give effect to inventories of stock on hand, on a basis consistent with that of the preceding year.

6. Report relating to statement of the assets and liabilities of certain funds and statement of revenues collected and expenses paid, on a cash basis (paragraph in report explains basis):

We have examined the financial statements of the _____ Institute relating to its private endowment funds and gifts as of June 30, 19____ and for the year then ended. Our examination was made in accordance with generally accepted auditing standards,

and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Institute maintains its accounts on a cash basis and does not accrue income and expenses. Amounts invested in land, buildings, furniture, equipment, works of art, and certain other similar property are not included in the accounts; the amounts of investment in such properties are not readily determinable. Current expenditures for such properties are included among expenses.

In our opinion, the accompanying statements present fairly the assets and liabilities of the private endowment funds of the _____ Institute at June 30, 19____, and the revenues collected and expenses paid for the year then ended, on the cash basis described in the preceding paragraph, which basis is consistent with that of the preceding year.

Sole Proprietorships

Reporting on the accounts of sole proprietorships involves consideration of several problems. The assets employed in a sole proprietor's business activity are in general available for his personal liabilities. Further, he sometimes mingles personal assets, liabilities, and transactions with those of the business or, in contrast, considers that obligations incurred to acquire certain assets used in the business are personal, not business, obligations. As his business activity is often conducted on a small scale, his records may be inadequate, supporting documents not available, or the record keeping may be performed without an understanding of its objectives.

When the records are adequate and auditable, and they relate to an identifiable entity — that is, to one or more specific enterprises — an opinion report is appropriate. The fact that the statements relate to one or more specific activities or business enterprises should be disclosed in the statements, and the fact that they relate to a sole proprietorship should be disclosed in the scope paragraph of the report and in the financial statements as well.

The following discussion of problems common to sole proprietorships deals with both the cash basis and accrual basis of accounting.

Personal Assets and Liabilities. If personal assets or liabilities of the proprietor are commingled with those of the sole proprietorship, the independent auditor should express no opinion unless he is satisfied that he has been able to ascertain all the facts and adequate dis-

closure has been made in the statements. He may instead describe the nature and extent of his examination and state that he is unable to express an opinion.

If it comes to his attention that any of the assets of the business are to be used for the payment of personal liabilities of the proprietor, or vice versa, the facts should be disclosed.

Income Taxes. Income taxes on the income of a sole proprietorship are payable by the proprietor on the basis of his net income from all sources. The existence of a final taxable income, the amount of taxes, if any, payable on the profits of the special activity, and the amount, if any, which will be withdrawn from the enterprise for the purpose of paying the taxes may be unknown to the independent auditor.

When the amount of the taxes or the amount which will be withdrawn for their payment is known, disclosure should be made. Even if the amount is not known, disclosure should be made of the fact that the statements do not include provision for income taxes which may be payable by the proprietor on the earnings of the enterprise. In neither case is a qualification required after full disclosure is made in the statements. If the reporting covers all of the proprietor's income-producing activities, it would in most cases be appropriate to account for income taxes in both the balance sheet and the statement of earnings in substantially the same manner as for corporate enterprises.

Salary of Proprietor. A so-called salary paid to a sole proprietor is essentially in the nature of drawings against profits and is preferably reported as such rather than as an expense of doing business. Some accountants feel, however, that the statements are more useful and informative if a reasonable allowance for the proprietor's services is reflected among expenses. The inclusion or omission of such an expense is, therefore, not a cause for qualification provided the practice followed is disclosed or is plainly evident.

Writing Up Records. Small businesses often have inadequate records. The independent auditor may be required to write up the books or make numerous adjusting entries and prepare the financial statements. The independent auditor is not necessarily lacking in independence simply because he has performed these services.* Although he often does make disclosure of work he has performed, disclosure of these services is not necessary if in the circumstances of a particular

*For a contrary viewpoint taken by the SEC, see Accounting Series Release No. 47.

engagement the independent auditor considers himself to be, in fact, independent. If possible, the examination should be conducted by staff members who were not associated with the original accounting work.

Examples of Reports:

1. Report on sole proprietorship whose accounts are on a cash basis (note to financial statements describes basis and mentions omission of inventories receivables, etc.):

We have examined the financial statements, which were prepared on a cash basis, of _____ Garage, a sole proprietorship as of November 30, 19__ and for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The following statements are presented:

Statement of Assets and Liabilities
resulting from cash transactions.

Statement of Cash Receipts and Disbursements on
account of Income and Expenses.

In our opinion, these statements present fairly the assets and liabilities at November 30, 19__ resulting from cash transactions of _____ Garage, and its receipts on account of income and disbursements on account of expenses for the year then ended, on a basis consistent with that of the preceding year.

2. Report on sole proprietorship whose accounts are on a modified cash basis:

We have examined the following statements relating to the accounts of the hardware business conducted as a sole proprietorship at _____ as of December 31, 19__ and for the year then ended:

Statement of Assets and Liabilities on a cash basis,
adjusted to give effect to inventory of stock on hand.
Statement of Income Collected and Expenses Disbursed,
on a cash basis, adjusted to give effect to inventories
of stock on hand at beginning and end of the year.

Our examination was made in accordance with generally accepted

auditing standards, and accordingly included such tests of accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, these statements present fairly the assets and liabilities as of December 31, 19____, on a cash basis, of the hardware business conducted at _____, and the income collected and expenses disbursed for the year then ended, both as adjusted to give effect to inventories of stock on hand, on a basis consistent with that of the preceding year. However, since receivables, payables, and accrued income and expenses which are material in amount are not reflected, the statements do not, in our opinion, present financial position or the results of operations.

3. Report on sole proprietorship whose accounts are on a cash basis (statements are not footnoted to disclose that a salary has been paid to the proprietor and that no provision has been made for income taxes; statements are footnoted to indicate that inventories, receivables and accruals are omitted):

We have examined the following statements relating to the accounts of a gift shop business conducted as a sole proprietorship at (address) under the name of _____ as of October 31, 19____ and for the year then ended:

Statement of Assets and Liabilities arising
from Cash Receipts and Disbursements.

Statement of Cash Receipts and Disbursements
on account of Income and Expenses.

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Salary payments made to the proprietor during the year are recorded as personal withdrawals. No provision has been made for income taxes paid or payable by the proprietor on the income earned by the enterprise.

In our opinion, the accompanying statements present fairly the assets and liabilities as of October 31, 19____ arising from cash receipts and disbursements of the gift shop known as _____, and the cash receipts and disbursements on account of income and expenses for the year then ended, on a basis consistent with that of the preceding year.

4. Report on a sole proprietorship whose accounts are on a cash basis (a disclaimer of opinion is expressed by the independent auditor because of commingling of personal liabilities and expenses of the proprietor with the general assets, liabilities and expenses of the enterprise and inadequate financial records; footnote describes cash basis and nature of omissions):

We have examined the accompanying financial statements relating to the accounts of a sports-wear shop business conducted by you as a sole proprietorship at _____ as of December 31, 19____ and for the year then ended.

Our review of the cash disbursements has disclosed that certain living expenses and the purchase of an automobile for your personal use have been recorded as expenses of the sole proprietorship. In addition it has been disclosed that certain assets of the business have been pledged as collateral for a personal bank loan. Because of the general inadequacy of the related financial records, we were unable to ascertain all the facts regarding the foregoing matters. In all other respects our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In view of the circumstances noted in the preceding paragraph, we are unable to express an opinion on the fairness with which the accompanying statements present the assets and liabilities at December 31, 19____ of the sports-wear shop conducted by you at _____, and the cash receipts from revenues and disbursements for expenses for the year then ended.

Partnerships

A partnership may be considered as an accounting entity since provisions of the partnership agreement impart fairly definite limits to it. The existence of this agreement and the vigilance of the partners generally results in more precise accounting and often a greater measure of control than exists in sole proprietorships. In common with sole proprietorships, partnerships sometimes have records which are not auditable. Certain characteristic problems of partnerships relate to income taxes, partners' salaries, and personal assets and liabilities of the partners. Many of these problems are similar to those discussed under "Sole Proprietorships."

Income Taxes. Income taxes on the income of a partnership are payable by the individual partners. In these circumstances it is rarely

possible to determine the extent to which working capital will be reduced by the withdrawal of funds to pay the partners' income taxes or to determine how much is payable on the profits earned from the business. A computation of such amounts could normally be made only on the basis of information furnished by the partners.

In view of the fact that these taxes are payable by the partners individually it is believed to be adequate to disclose the fact (preferably in the financial statements) that no provision has been made for income taxes and to state the amount, if proper information is furnished, of withdrawals which the partners expect to make for tax purposes. If the financial statements do not make this disclosure the independent auditor's report should include it as an explanation. It is not necessary to qualify the independent auditor's opinion because of the omission of a provision for income taxes.

Salaries of Partners. Partnerships differ in the matter of paying salaries to partners. Some pay equal salaries to all; some pay salaries which vary among the partners; some pay none; others pay salaries to some partners and none to others. Some treat the salaries as expense. Others regard them as personal withdrawals.

In some instances it may be desired to show the return from the business without charging partners' salaries to expense. In others, the statements are more useful to the partners if partners' salaries, so described, are taken up in the appropriate expense categories.

As a result of these variations, partnership income statements do not always show net income on comparable bases. Ordinarily, however, the income from operations in enterprises so organized is not publicized for statistical purposes and is of concern only to persons who may be apprised of the facts. For this reason it is regarded as sufficient to disclose the practice followed, usually in the form of a footnote to the income statement.

Personal Assets and Liabilities. Personal assets and liabilities of the partners not applicable to partnership operations should be excluded from partnership statements.

If it is known that partnership assets are to be used for the payment of a material amount of personal liabilities of any of the partners, disclosure should be made, preferably in the financial statements.

Examples of Reports:

1. Report on a partnership whose accounts are on a cash basis (statements are footnoted to indicate that inventories, receivables and accruals are omitted):

We have examined the accompanying statement of assets and liabilities resulting from cash transactions of the partnership of _____ and _____ as of September 30, 19____, and the related statement of cash receipts on account of income and disbursements on account of expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, these statements present fairly the assets and liabilities at September 30, 19____ resulting from cash transactions of the partnership of _____ and _____, and the income collected and expenses disbursed during the year then ended, on a basis consistent with that of the preceding year.

2. Report on a partnership whose records are maintained on a cash basis, except that inventories are recorded:

We have examined the following statements of the partnership of _____, _____ and _____:

Statement of Assets and Liabilities, on a cash basis except for the inclusion of the inventories, as at December 31, 19____.

Statement of Cash Receipts from revenues received and Cash Disbursements for expenses paid for the year ended December 31, 19____, adjusted for beginning and ending inventories.

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The partnership employs a modified cash basis of accounting which includes the recording of inventories but omits accounts receivable, accounts payable and accrued income and expense. Accordingly, the accompanying statements do not, in our opinion, present financial position or results of operations.

In our opinion, the afore-mentioned statements present fairly, on the basis described in the preceding paragraph, which is consistent with that of the preceding year, the assets and liabilities of the partnership of _____, _____ and _____ at December 31, 19____ resulting from cash transactions and the revenues received and expenses paid during the year then ended.

3. Example 5 under the heading "Cash Basis Statements — General" is another illustration of a special report on a partnership.

Personal Accounts

Because of the nature of personal assets and liabilities (i.e., those not associated with the running of a business) and the absence of control over the creation and recording of personal liabilities, personal accounts are frequently considered not to be susceptible of satisfactory audit. Reports on the examination of personal accounts kept on an accrual basis should describe the nature and extent of the examination (in a form approaching that of a long-form report) and when the independent auditor's knowledge of the transactions is limited to those recorded or which are disclosed to him, his report should contain a disclaimer of opinion.

A disclaimer paragraph may be similar to the following:

We are unable to express an opinion as to the fairness with which the accompanying statements present financial position or operating results, as our knowledge of personal assets, liabilities, and transactions is necessarily limited to those appearing in the records or otherwise disclosed to us. Our examination did not disclose anything which required reservations as to the information shown.

When the accounts are kept on a cash basis, that fact should be stated and the nature of the omissions described. A disclaimer is not required for cash basis statements if adequate disclosure of the limitations of the examination is made and if the statements do not purport to reflect financial position and results of operations. The opinion should contain an expression as to the fairness of the presentation of the data the statements present on the basis indicated. The use of the descriptive word *recorded* as a prefix to "cash receipts and disbursements" may also be used.

Examples of Reports:

1. Long-form report on accounts kept on a cash basis:

We have made an examination of the personal accounts maintained by you for the year ended December 31, 19____, and present the following:

Statement of Assets and Liabilities, December 31, 19____, on
a cash basis.

Statement of Recorded Cash Receipts and Disbursements on

account of income and expenses for the year ended December 31, 19__.

The nature of personal accounts, with the absence of control over the creation and recording of personal liabilities, etc., makes an examination of any but recorded transactions impracticable. Our examination was made in accordance with generally accepted auditing standards and accordingly included such tests as we considered necessary in the circumstances.

[Description of audit procedures which were followed.]

The accounts are kept on a cash basis and therefore accounts receivable or payable other than for loans, or accrued income and expenses, which are material in amount, are not included.

A loan of \$_____ to a former employee whose address is unknown is of doubtful collectibility.

In our opinion, except for the doubtful collectibility of the loan referred to in the preceding paragraph, the foregoing statements present fairly the assets and liabilities, resulting from recorded cash transactions, of _____ as of December 31, 19__ and the recorded cash receipts and disbursements on account of income and expenses for the year then ended, on a basis consistent with that of the preceding year.

2. Report on accounts on a cash basis, except that interest income on loans receivable and investments is accrued:

We have made an examination of the accompanying statements of your personal account as of June 30, 19__, and for the year then ended, prepared on a cash basis except for the inclusion of accrued interest income on loans receivable and investments. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statement of assets and liabilities, and the statement of recorded cash collections of income and cash disbursements of expenses present fairly the assets and liabilities of Mr. _____ as of June 30, 19__, on a cash basis, except for the inclusion of accrued interest income on loans receivable and investments (which basis is consistent with that of the preceding year), and the recorded cash collections of income and cash disbursements of expenses for the year then ended.

Estates, Trusts, and Guardianships

The primary object in estate accounting is accountability. The primary purpose of the records is to facilitate the preparation of reports which executors, administrators, trustees, and guardians are required to file with the courts and beneficiaries.

In these reports the question of financial position or results of operations does not usually arise. Usually the accounts are kept on a cash basis. Liabilities of a decedent are not taken up until they are paid. Personal property received as part of principal may be carried at estimated or nominal amounts. Capital stocks of closely held companies, which often are not readily marketable, may be carried at amounts arbitrarily arrived at. The distribution of profits, losses, and expenses between principal and income is governed by law and is designed to protect the rights of the interested parties. Except as to the accounts of a business taken over and carried on as a principal asset, profits and losses on assets disposed of are treated as adjustments of principal, and allowances are not made for depreciation.

Since the statements do not purport to present financial position or results of operations, the wording of the opinion should be suited to the content of the statements. If in any instance the accrual basis was used and the statements did purport to present financial position and operating results, the standard short-form report, qualified where necessary, would of course be appropriate. Frequently these reports take on the aspects of long-form reports.

Examples of Reports:

1. Report on examination of accounts, on a cash basis, of executors:

We have examined the following schedules relating to your transactions as Executors of the Estate of _____ for the period from _____, date of the death of _____, to _____:

(List of Schedules)

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The investment in 25,000 shares (entire issue) of capital stock of _____ Company, Inc., which is being offered for sale, is stated at the estimated fair market value used for Federal estate tax purposes. All other accounts are kept on a cash basis.

In our opinion, these schedules present fairly the cash receipts and disbursements on account of principal and income and the amounts disbursed to beneficiaries during the period from _____ to _____, and the amounts of assets and liabilities, on a cash basis except as indicated in the preceding paragraph, remaining on hand at _____.

2. Report on examination of accounts of trustees on a cash basis:

We have examined the statement of assets, liabilities, and principal, on a cash basis, at December 31, 19__ of the trustees under a Trust Fund established by _____, deceased, for _____, and the related statement of cash receipts of income and disbursements of expenses of the Trust for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, these statements present fairly the assets, liabilities, and principal of the Trust, on a cash basis, at December 31, 19__, and the cash receipts of income and disbursements of expenses for the year then ended, on a basis consistent with that of the preceding year.

3. Report (containing procedural and explanatory comments) on examination of accounts of trustees on a cash basis:

We have examined the statement of net assets and trust principal at February 28, 19__ of the Trust established by _____ for _____ and _____, prepared on a cash basis, and the related statement of cash receipts of income and disbursements of expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The accounts are kept on the basis of cash receipts and disbursements and therefore do not include accruals of income, expenses, trustees' commissions, and income taxes.

Cash on deposit at February 28, 19__ was confirmed by the depository. The cash receipts and disbursements shown by the records were reconciled with the total deposits and total charges appearing on the bank statements.

Brokers' advices were examined in support of security transactions and dividends received were compared with published records of dividend declarations. All interest on bonds owned was found to be accounted for.

In our opinion, the accompanying statement of net assets and trust principal and statement of cash receipts of income and disbursements of expenses present fairly, on a cash basis consistent with that of the preceding year, the net assets and trust principal of the _____ Trust for _____ and _____ at February 28, 19__ and the income and expenses for the year then ended.

4. Long-form report on examination of accounts of trustees for two trusts, kept on a modified cash basis:

We have examined the statements of net assets of the _____ and _____ Trusts (_____, grantor) as of December 31, 19__ and the related statements of cash receipts and expenditures and trust principal for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The net income of the Trusts, which were created by _____ for the benefit of his children, is not distributable until the beneficiaries are twenty-one years old. One of the beneficiaries will reach that age on _____.

The _____ National Bank of _____ confirmed the amount of cash on deposit.

We counted the securities on hand on January 15, 19__ and examined all security transactions for the year and from January 1 to 15, 19__. Investments in capital stocks are carried in the accounts on the basis used for Federal income tax purposes, representing the cost of purchased securities and, as to contributed securities, the lower of donors' cost or market value at the date of the gift. Dividends received were compared with published statistics of dividend payments.

We examined the mortgage loan agreement, obtained confirmation of the balance receivable, and determined that interest received on the loan during the year was in accordance with the terms of the agreement.

The accounts are kept on a cash basis, except that they include

the Trusts' share of net earnings or losses of _____ Company (a partnership) as shown by unaudited statements of that organization and by a confirmation obtained from it. Accrued interest on the mortgage and dividends on the stocks owned, declared before year-end dates and payable in the following year, are not taken into the accounts until they are received, and accrued expenses, including income taxes on trust income, are not taken up until they are paid.

In our opinion, except for any facts which an audit of the partnership referred to in the preceding paragraph may reveal, the accompanying statements present fairly the assets and liabilities of the Trusts at December 31, 19____, and their cash receipts and disbursements for the year then ended, on a cash basis adjusted to give effect to the equity of the Trusts in the net earnings or losses of the partnership doing business as _____ Company, as described in the preceding paragraphs. Such presentation is consistent with that used in the preceding year.

Farms

For purposes of this section the term *farm* is considered to include dairy, fruit, poultry, livestock, and truck farms, and plantations, ranches, groves, and other land used for farming operations. A farm may be operated as a sole proprietorship, partnership, corporation, joint venture, or fiduciary, functioning either as owner or as tenant.

Small farms, especially those which are sole proprietorships, share with other small enterprises the problems of unauditable records. In 1952 the Farms Committee of Robert Morris Associates issued a printed form for financial statements of agricultural enterprises, with the comment that "the banker in many instances must fill out the statement for the farmer. Much of the information is furnished from memory rather than the farmer's records."¹

When accounts are not auditable the independent auditor can of course do no more than describe the work done and disclaim an opinion on the fairness of the statements as a whole.

The special problems which characterize farm accounting have to do largely with the carrying amounts of unharvested crops and of farm produce and livestock.

¹ Robert Morris Associates Bulletin, Sept. 1952, p. 8.

Farm Produce and Livestock. Detailed records and physical control which are entirely feasible in a factory are not always equally feasible on a farm. Without elaborate records, the cost of livestock or produce sold or held for sale cannot always be accurately determined. For this reason farmers often price their inventories on the basis of *farm prices*, which are selling price in the nearest local market less the cost of marketing. Livestock is often priced on the unit-livestock-price method, under which a standard unit price for each class and age is placed on animals which have been raised or have been purchased before maturity and raised. Purchased livestock used for work, dairy, or breeding purposes is usually capitalized and depreciated.

These two methods of pricing inventories are widely used in farming operations and, where an accurate determination of cost is not feasible, are believed to be a practical substitute for the *lower of cost or market* method of pricing. The Internal Revenue Service has recognized both bases.

The method of pricing inventories should be clearly disclosed.

Unharvested Crops. Farmers who grow crops which do not mature until after the end of the fiscal year have costs which are properly carried forward until the crop is realized. If these costs are not deferred, and the records are maintained on an accrual basis, an exception usually should be taken in the opinion paragraph, accompanied by a rough approximation of costs or, in their stead, disclosure of the approximate acreage and the nature of the crop. On a cash basis method of accounting, disclosure of the approximate acreage planted but not matured and the nature of the crop may be made.

Income Taxes and Proprietors' Salaries. The handling of income tax provisions and salaries paid to partners and sole proprietors, where the farming enterprise is being conducted as a sole proprietorship or partnership, is discussed in prior sections, see pages 18 and 22.

Depreciation. Many accountants believe that "true" cash basis statements should not reflect depreciation. Others believe that depreciation is permissible in such cases since it originated in a property acquisition usually for cash. Income tax regulations require the taking of depreciation in a cash basis return. In many cases the engagement requires the preparation of income tax returns, or their review, in conjunction with the audit of the statements, and the statements generally reflect this determination. For this reason financial statements of farms prepared on a cash basis frequently include depreciation.

Examples of Reports (see also examples in section on sole proprietorships and partnerships):

1. Report on sole proprietorship whose accounts are on a cash basis without depreciation (footnote fully describes basis):

We have examined the accompanying statements of the farm operated by you as a sole proprietorship as of December 31, 19___ and for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The accompanying statements are:

Statement of Assets and Liabilities resulting from cash transactions.

Statement of Cash Receipts and Disbursements on account of income and expenses.

In our opinion, these statements present fairly the assets and liabilities at December 31, 19___, resulting from cash transactions, of the farm operated by you, and the cash transactions of income and expenses for the year then ended, on a basis consistent with that of the preceding year.

2. Report on partnership whose accounts are on a cash basis plus depreciation (a qualification of the independent auditor's opinion is made because of a restatement of the costs of the farm buildings during the current year to appraisal value):

We have examined the accompanying financial statements of _____ Farm operated as a partnership as of November 30, 19___ and for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The statements are prepared on a cash basis but include depreciation of buildings and equipment. The statement of assets and liabilities does not include the costs applicable to _____ acres of _____ which are planted but will not mature until April 19___; the cash expenditures involved in planting this acreage is included among the expenses. In addition, inventories of livestock and supplies, and receivables from packers are not reflected in these statements.

An appraisal of the farm buildings was made on July 31, 19____ by the _____ Company and a total of \$_____ was submitted as the current replacement value. The accounts have been adjusted for the increase of \$_____ over the original cost recorded in the accounts, and an offsetting credit made to the partners' capital accounts.

In our opinion, except as noted in the preceding paragraph, the accompanying statements present fairly the assets and liabilities of _____ Farm as of November 30, 19____, arising from cash transactions, and the cash collections and disbursements on account of income and expense for the year then ended, on a basis consistent with that of the preceding year.

Churches, Community Funds, and Other Religious, Charitable, or Cultural Organizations

Under this heading come a variety of nonprofit organizations. They have special problems which relate to the control of receipts, the method of handling pledges, the accounting treatment of property, and the use of the cash or modified cash basis of accounting. Certain aspects of accrual accounting are included at times in the discussion to provide additional background for the reader.

Income from Voluntary Contributions. The degree of physical safeguard against appropriations by solicitors or others of funds received as contributions varies greatly. Probably no system of control is a complete deterrent, nor would a complete detailed audit disclose every withholding of contributions.

In the absence of suspicious circumstances, practice has sanctioned the expression of an opinion as to the fairness of a statement of cash receipts and disbursements even though part or all of the receipts arise from voluntary contributions. However, when the independent auditor lacks the means of determining that the large majority of such contributions have been accounted for, or the scope of his examination is restricted in this respect, some clarification may be desirable in the scope paragraph and/or through the use of the word *recorded* in describing receipts.

Pledges. Practice varies with respect to the disclosure and treatment of pledges receivable. Organizations using an accrual basis may record pledges in full, reduced by an appropriate allowance for uncollectible pledges; some provide an allowance in the full amount of the pledges.

Organizations on a cash basis either disclose anticipated collections of pledges by footnote or omit mention of pledges. Independent auditors usually do not require qualifications of their opinions when disclosures of pledges are omitted. The usual confirmation procedures are recommended whenever pledges receivable are disclosed, regardless of the form of the disclosure.

Property. Organizations of this character often receive gifts of property. The existence of such property, other than minor items, not carried on the books is usually disclosed. It is, of course, acceptable (and preferable) procedure to record such items and also to record reasonable allowances for depreciation of income producing property having a limited existence. Many organizations of this type using a cash basis of accounting, especially those which own no buildings and do not have a great deal of equipment, charge disbursements for office equipment, supplies, etc., to expense at the time the disbursements are made. When this procedure is followed disclosure should be made in the report if the amounts involved are material in any one year or on a cumulative basis.

Independence. Independent auditors often contribute services to organizations of this type by serving as directors or furnishing assistance in the installation of records and subsequent record keeping. If they also audit the accounts, it is usually desirable to disclose their connection with the process of policy making or of record keeping. Independent auditors who actually handle funds or engage in any other activities which would impair independence should refrain from expressing an opinion.

Examples of Reports: The examples given here illustrate some of the situations encountered in practice.

Churches:

1. Report on examination of statement of cash receipts and disbursements of a church:

We have examined the statement of cash receipts and disbursements of _____ Church and the summary of cash receipts and disbursements by funds, both for the year ended December 31, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of

the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement of cash receipts and disbursements and the summary of cash receipts and disbursements by funds present fairly the recorded cash transactions of _____ Church for the year ended September 30, 19____, on a basis consistent with that of the preceding year.

2. Report on examination of the accounts of a diocese kept on the cash basis, except that pledges receivable are recorded:

We have examined the statement of assets and liabilities of the Diocese of _____ as of December 31, 19____ (on a cash basis except for the inclusion of pledges receivable) and the related statements of cash receipts and cash disbursements and of changes in fund balances for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As the books are kept substantially on a cash basis, the only exception being the recording of pledges receivable, the accompanying statements do not include accrued interest receivable at December 31, 19____ amounting to approximately \$_____ and December expenses paid in January amounting to approximately \$_____, nor has allowance been made for depreciation of property or for possible losses in the collection of past due pledges or property advances. Balances of the general and property funds are unavailable to the extent that these pledges and advances prove to be uncollectible or are canceled by action of the Executive Council. Various mission and aided parish properties on which title is apparently held in the name of the Diocese are not included in the property accounts. Mr. _____ informs us that records of ownership covering these properties, almost all of which were acquired before 19____, have never been maintained in the files of the Diocese. Liens against these properties, if any, might become a liability of the Diocese in the event of delinquency by the individual churches managing the properties.

In our opinion, with the explanation in the preceding paragraph, the accompanying statement of assets and liabilities and statements of cash receipts and cash disbursements and of changes in fund balances present fairly the assets and liabilities of the Diocese of

_____ at December 31, 19__ on a cash basis except for the inclusion of pledges receivable, and its recorded cash transactions and the changes in fund balances for the year then ended, on a basis consistent with that of the preceding year.

3. Report on examination of the cash basis statements of a church:

We have examined the statement of assets and liabilities of _____ Church of _____ as of December 31, 19__, resulting from cash transactions, and related statement of cash receipts and disbursements on account of income and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

As the accounts are kept on a cash basis, pledges receivable, accrued interest receivable on investments, and a minor amount of accrued payroll and other expenses are not taken into account, nor has any allowance been made for depreciation of buildings and equipment.

In our opinion, the accompanying statements present fairly the assets and liabilities of _____ Church of _____ at December 31, 19__ resulting from recorded cash transactions, and the income collected and expenses disbursed during the year then ended, on a basis consistent with that of the preceding year.

Community Funds:

4. Report on examination of cash basis statements and disclosure that a member of the independent auditor's firm is serving the fund in an official capacity:

We have examined the statement of assets and liabilities (on a cash basis), of the Community Fund of _____, Inc., as of June 30, 19__, and the related statement of cash receipts from revenues collected and disbursements for expenses paid for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

No accruals are made of income or expenses. The Fund records pledges as they are received, for purposes of statistical information and internal control, and offsets them with a reserve for the total

amount. It charges all purchases of furniture and equipment directly to expense but, for control purposes, records them as assets and offsets the total amount with a reserve. The result is that assets, liabilities, income, and expenses are stated on a cash basis.

In our opinion, the accompanying statements present fairly the assets and liabilities, resulting from cash transactions, of the Community Fund of _____, Inc., as of June 30, 19____, and the recorded cash receipts and disbursements for the year then ended, on a basis consistent with that of the preceding year. Mr. _____, a partner of this firm, is a director of Community Fund of _____, Inc., but he did not take part in our examination.

5. Report on mid-year examination (first fiscal period) of accounts kept on a modified cash basis, containing procedural comments making it equivalent to a long-form report:

We have examined the assets and liabilities of The Community Chest, Inc., as of June 30, 19____ arising from cash transactions, and the statement of cash receipts and disbursements on account of income and expenses for the period from January 10 to June 30, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We counted cash on hand at June 30, 19____ and obtained confirmation of amounts on deposit with banks.

On July 11, 19____ we examined the securities owned, consisting of (a) United States savings bonds, Series F (\$_____, of which \$_____ has been earmarked as a special fund for employee retirement payments), (b) United States savings bonds, Series G (\$_____) and United States treasury tax notes (\$_____) representing a part of the current or pledge funds, and (c) United States savings bonds, Series G (\$_____) and a first mortgage note (\$_____) held in the building and endowment fund.

We supervised the mailing of statements of account as of June 30, 19____ to individual donors having open balances. The statements included a request that donors notify us of any exceptions. All exceptions reported were satisfactorily explained. We satisfied ourselves that the procedures followed in accounting for pledges are reasonable.

All insurance policies were examined.

In our opinion, except for the inclusion of pledges receivable, the accompanying statements present fairly the assets and liabilities, arising from cash transactions, of The Community Chest, Inc., as of June 30, 19__ and the recorded cash transactions of income and expense for the period January 10, 19__ to June 30, 19__.

6. Report on examination of accounts, kept on a cash basis, of a society in which the independent auditors served as officers or accounting assistants:

We have examined the statement of assets and liabilities, on a cash basis, of _____ Society of America as of October 31, 19__, and the related statement of cash revenues received and expenses paid for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances and in the light of the relationship described in the following paragraph.

Members and employees of our firm have functioned as officers or accounting assistants for the Society (in capacities not involving the handling of funds) since its inception, and in such capacities have formulated accounting policies and routines employed by the Society.

In our opinion, the accompanying statement of assets and liabilities and the statement of cash revenues received and expenses paid present fairly, on a cash basis, the assets and liabilities of _____ Society of America at October 31, 19__ and the recorded cash revenues received and expenses paid for the year then ended, on a basis consistent with that of the preceding year.

Other Religious, Charitable, or Cultural Organizations: (See also several examples under section on Cash Basis Statements — General.)

Clubs

The problems encountered in reporting on clubs are mainly concerned with use of the cash basis or the modified cash basis, with the accounting for cash receipts, with the accounting treatment of property, and with the matter of independence. These subjects have been discussed in some of the preceding sections.

If the club records are kept on the accrual basis, exceptions relating to depreciation policies, inventory observation, and confirmation

of receivables may be somewhat more frequent than in commercial organizations.

Examples of Reports:

1. Report on examination of accounts kept on the cash basis (certain disclosures, preferably included among the notes to financial statements, are included in the report):

We have examined the statement of assets and liabilities (on a cash basis) of the national executive office of _____ as of July 31, 19__ and the related statements of cash receipts and disbursements on account of income collected and expenses disbursed and of changes in fund balances for the year then ended. The accounts of the national organization, the subject of this examination, are separate and distinct from the accounts under the primary control of the chapters of _____, which are kept at the various universities and colleges and were not examined by us. Our examination of the financial statements of the national executive office was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

With minor exceptions, the accounts are kept on the basis of cash receipts and disbursements. Accordingly, income from investments, notes, and other sources is not recorded until collected and disbursements for office equipment, supplies, etc., are charged to expense when the disbursement is made. The accompanying statements therefore do not give effect to accrued income, accrued or prepaid expenses, or the value of equipment owned.

Funds were remitted to the national office during the year by 42 of the 50 chapters. These remittances were in agreement with reports supplied by other public accountants conducting examinations of the accounts of these chapters.

The segregation of funds in the financial statements is in accordance with practices adopted in prior periods. The fund accounting of _____ is not bound by formal fund agreements and is subject to the discretion of the Grand Council.

In our opinion, the accompanying statements present fairly, on a cash basis, the assets and liabilities of the national executive office of _____ at July 31, 19__, its cash transactions of income collected and expenses disbursed, and changes in

fund balances for the year, on a basis consistent with that used in the preceding year.

2. Report relating to accounts kept on the cash basis (includes a comment regarding the examination of cash receipts from contributions):

We have examined the assets and liabilities, resulting from cash transactions, of _____ Club of _____ as of December 31, 19____ and the related statement of income collected and expenses paid, on a cash basis, for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. Our examination of receipts from voluntary contributions was limited to test comparisons of duplicate deposit tickets, representing the recorded receipts from all sources, with the cash receipts record and with the bank statements. The nature of voluntary contributions is such that it is impracticable to audit them.

In our opinion, the accompanying statements present fairly the assets and liabilities of _____ Club of _____ at December 31, 19____, resulting from cash transactions, and the recorded income collected and expenses paid, on a cash basis, for the year then ended, on a basis consistent with that of the preceding year.

SECTION II

Nonprofit Organizations Which Follow Special Accounting Practices

Paragraph 3b of Statement on Auditing Procedure No. 28 describes these special report circumstances as including:

Reports on financial statements of some nonprofit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit. These organizations may include municipalities, hospitals, co-operatives, and educational institutions.

Nonprofit organizations, whose accounting practices place them within this category, are subject to the second, third and fourth standards of reporting as described on page 9 under "Cash or Other Incomplete Accounting Bases" (Paragraphs 12, 13, and 14 of Statement on Auditing Procedure No. 28). The application of the first standard of reporting, requiring an opinion as to the conformity of financial statements with generally accepted accounting principles, is clarified with regard to these organizations in Paragraph 11 of Statement No. 28 as follows:

11. If the statements are those of a nonprofit organization they may reflect accounting practices differing in some respects from those followed by business enterprises organized for profit. It is recognized that in many cases generally accepted accounting principles applicable to nonprofit organizations have not been as clearly defined as have those applicable to business enterprises organized for profit. In those areas where the auditor believes generally accepted accounting prin-

ciples have been clearly defined (as indicated by authoritative literature and accepted practice, etc.) he may state his opinion as to the conformity of the financial statements either with generally accepted accounting principles, or (alternatively, but less desirably) with accounting practices for nonprofit organizations in the particular field (e.g., hospitals, educational institutions, etc.), and in such circumstances he may refer to financial position and results of operations; in either event, it is assumed that the auditor is satisfied that the application of such accounting principles and practices results in a fair presentation of financial position and results of operations or that he will state his exceptions thereto. In those areas where the auditor believes generally accepted accounting principles have not been clearly defined, the other provisions of this statement apply.

The above-quoted paragraph imposes upon the independent auditor the responsibility for determining whether generally accepted accounting principles have been clearly defined for a particular type of activity. It implies that such definition can be assumed only when authoritative literature defines the practices considered acceptable and such principles have become generally accepted in practice through the adoption, by a large majority of those in the particular field, of substantially all the recommendations contained in the literature. These are colleges and universities, municipalities, and hospitals. The sections that follow are intended to guide the independent auditor in determining whether the statements may be considered to be in conformity with the generally accepted accounting principles for the "particular field."

Colleges and Universities

The accounting problems of nonprofit institutions of higher learning have been the subject of extended study and no little debate by representative committees.

In 1930 the National Committee on Standard Reports for Institutions of Higher Education was organized in response to a need expressed by many institutions and by the United States Office of Education for recognized standards of accounting and financial reporting for colleges and universities. The committee's report was published in 1935 under the title *Financial Reports for Colleges and Universities*. It contained a statement of principles of accounting and reporting which was accepted and applied in most institutions throughout the country.¹

¹ *The Journal of Accountancy*, Volume 90, page 205.

In 1952 the American Council on Education published Volume I of a two-volume report entitled *College and University Business Administration*, which included a revision of the principles contained in *Financial Reports for Colleges and Universities*. This volume was prepared by the National Committee on the Preparation of a Manual on College and University Business Administration, in consultation with a special committee on college and university accounting of the American Institute of Certified Public Accountants.

The major areas in which the principles outlined in the aforementioned publication differ from generally accepted principles of accounting for profit-making organizations are discussed in the following paragraphs.

Depreciation. One of the most troublesome accounting problems of educational institutions deals with depreciation. The conclusions as to the accounting treatment of depreciation expressed in *College and University Business Administration* follow in substance those previously expressed in *Financial Reports for Colleges and Universities*, and are stated as follows:

- (a) Since, in general, the property used specifically for the educational functions of the institution was initially provided by gifts, grants, or legislative appropriations, and since such property is ordinarily replaced in like manner, it is not necessary to accumulate funds out of current income for renewals or replacements. See Appendix B for a discussion of the principles relating to depreciation of real property held by educational institutions.
- (b) It is desirable to make provision for renewals and replacements of institutional service property and of property used for auxiliary (dormitories, dining halls, etc.) or other income-producing activities. The necessity for making such provision will depend upon the financial program of the institution.
- (c) It is essential to provide for depreciation of real estate property held as investments of the endowment funds. A depreciation reserve, to be effective, requires a periodical transfer of cash from income to principal. This depreciation reserve should be included in the endowment funds group as a deduction from the related asset.
- (d) If replacement fund reserves for institutional property are created, they should be represented by cash or other liquid assets included in the plant funds group. A reserve account for replacements resulting merely from a journal entry without transfer of cash serves no useful purpose.²

² *College and University Business Administration*, Volume I, page 20.

Many educational institutions follow generally the recommendations outlined above regarding depreciation. However, some variations exist with respect to the policy of depreciating property used by auxiliary enterprises. Some of the schools which have large percentages of their enrollment in residence feel that dormitories and dining halls are an integral part of their educational plant and that such structures should not, therefore, be subject to depreciation accounting. This position is strengthened by the fact that the fees charged for such services are rarely designed to cover all costs incurred and that the construction and replacement of such facilities are frequently financed through gifts, public appropriation, or borrowing. These arguments are not without merit. Some independent auditors feel, accordingly, that institutions which do not depreciate auxiliary enterprise properties, as recommended by the manual, need not be considered in sufficient violation of generally accepted accounting principles as applied to educational institutions to warrant exceptions in their opinions.

Accrual Basis. Volume I of *College and University Business Administration* contains a recommendation that accounts be kept on a modified accrual basis. This, it explains, means inclusion of unpaid bills for materials received or services rendered, of income due or billed, and of allowances for probable losses, but does not mean the accrual of interest receivable or allocation of insurance premiums to later periods. The volume comments that the primary purpose of accounting in educational institutions is to report on the stewardship of the funds and property entrusted to the institution rather than to determine net profits and net worth, and that therefore some items of income need not be accrued and certain expenditures need not be prorated. The comment continues: "Few institutions find it either necessary or desirable to report accrued interest receivable, or to allocate insurance premiums to subsequent periods."³ (The consistent omission of accrued interest and prepaid insurance from the balance sheet would probably have no material effect upon financial position or results of operations.)

Profits and Losses on Sales of Securities. In the usual commercial organization, profits and losses on sales of securities are includable in income. In colleges and universities, however, profits and losses on sales of *investments held in endowment and other nonexpendable*

³ *College and University Business Administration*, Volume I, page 21.

funds are not taken into income but are considered to be part of the principal of the fund involved.

This procedure is in accordance with a general concept in the administration of trusts that, in the absence of specific provisions to the contrary, gains on sales of investments may not be distributed as income, and income may not be applied to the restoration of principal to the extent that principal has been depleted by losses.⁴ It is also the procedure recommended in Volume I of *College and University Business Administration*.⁵

Exclusion of profits and losses on sales of securities in endowment and other nonexpendable funds from the income of a college or university would not, therefore, warrant an exception in the independent auditor's report unless the exclusion is in violation of the terms under which the fund was established.

Repayment of Construction Loans. The *College Manual* provides that payments of principal amounts of loans made for construction of facilities may be charged against income at the time of payment. Although the manual contains no prohibition of a concurrent depreciation charge when such facilities fall within the "auxiliary enterprise" category, it would appear unrealistic to permit, in effect, such a double charge against operations in the same period.

Reporting Procedure. The use of accounting procedures recommended by the American Council of Education, though differing in some respects from those generally followed by business enterprises organized for profit, should not be the cause of a qualification of the independent auditor's opinion.

With respect to statements of nonprofit colleges and universities (and similar educational institutions) which conform substantially with the accounting procedures for nonprofit educational institutions recommended by the American Council on Education, the opinion expressed by the independent auditor should indicate, as permitted by Paragraph 11 of Statement on Auditing Procedure No. 28, that the statements present fairly financial position and the results of operations in conformity with generally accepted accounting principles or (alternatively, but less desirably) in conformity with accounting practices for nonprofit educational institutions.

The use of the term "generally accepted accounting principles"

⁴ *Bankers Trust Co. vs. May* (1953) 148 Misc. 38. 265 N.Y.S. 77.

⁵ *College and University Business Administration*, Volume I, pages 92-93.

in connection with a nonprofit organization (which is not employing principles generally followed by business at large) is specifically recommended for the first time by Statement on Auditing Procedure No. 28. Some independent auditors may feel reluctant to use this term in an opinion on statements of nonprofit organizations; they may wish to use it only in connection with those schools which follow the principles followed by enterprises organized for profit (e.g., record depreciation on all properties), and apply the alternative form to those which do not. Others may feel that the alternative form (referring to "accounting practices") should be used for a short transitional period. Some independent auditors prefer to use a form not specifically recommended by Statement No. 28, stating that the financial statements are "in conformity with generally accepted accounting principles for educational institutions," because they believe the unqualified term "generally accepted accounting principles" should, for the present, be applied only to enterprises organized for profit. They prefer to continue such usage, which would otherwise appear to be a redundancy, until either the preferred alternative becomes well established or the Accounting Principles Board issues a pronouncement placing the practices permitted by the manual squarely within the concept of the term "generally accepted accounting principles." Regardless of the terminology preferred by the independent auditor in any of these cases, the criterion for their usage is always the same, i.e., the independent auditor must believe that generally accepted accounting principles applicable to the particular nonprofit field have been clearly defined, as indicated by authoritative literature and accepted practice.

In the interest of clarity it is desirable to disclose, preferably as part of the financial statements, the practice followed regarding depreciation and the omission of any accruals which, if it were an enterprise organized for profit, would have a material effect upon either the financial position or results of operations.

Accounts kept on the cash basis are subject to the reporting standards described in the section of Statement on Auditing Procedure No. 28 relating to cash-basis statements. See pages 9 to 17 for discussion of cash basis statements.

Examples of Reports:

1. Report containing middle paragraph explaining accounting practices followed (a preferable alternative is to make such disclosure in the financial statements or notes to the financial statements):

We have examined the balance sheet of _____ Univer-

sity as of June 30, 19__ and the related statement of income and expenditures and general surplus, and changes in fund balances for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In accordance with practices followed by nonprofit educational institutions, no provision has been made for depreciation of educational plant nor has accrued interest receivable on investments or prepaid expenses been given effect in the accounts. Provision has been made for depreciation of property used in auxiliary operations.

In our opinion, the accompanying statements present fairly the financial position of _____ University at June 30, 19__ and the results of operations for the year then ended, in conformity with generally accepted accounting principles (or, with accounting practices generally followed by educational institutions) applied on a basis consistent with that of the preceding year.

2. Report containing paragraphs explaining accounting practices followed (which are not in conformity with *College Manual*) and the omission of a major asset (a preferable alternative is to make such disclosures in the notes to financial statements):

We have examined the balance sheet of _____ University as of June 30, 19__ and the related condensed statement of revenue and expenditures for the fiscal year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The university consistently keeps its accounts on the accrual basis, including accrual of interest on investments, and records depreciation of educational plant.

The accounts do not include among endowments any part of the indivisible corpus of The _____ Endowment, part of the income of which accrues to _____ University (\$_____ received in the current fiscal year), subject to the terms of an indenture dated _____, whereby Mr. _____ established a trust to be administered for educational and charitable purposes.

In our opinion, with the explanations in the two preceding para-

graphs, the accompanying balance sheet and condensed statement of revenue and expenditures present fairly the financial position of _____ University, at June 30, 19__ and the results of operations for the fiscal year then ended, in conformity with generally accepted accounting principles (or, with accounting practices generally followed by educational institutions) applied on a basis consistent with that of the preceding year.

3. Report qualified as to scope and opinion (notes on financial statements state that depreciation of educational plant, accrued interest receivable, and prepaid expenses are not taken into account):

We have examined the balance sheet of _____ College as of June 30, 19__ and the statements of operating income and expenses and operating fund deficit for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances, except that, as instructed by you, we did not obtain confirmation of the amount of \$_____ shown as due from _____, nor were we able to substantiate this receivable by alternative auditing procedures.

As more fully explained in Note ____ to financial statements, no provision was made during the year for amortization of improvements to and relocation of certain auxiliary facilities aggregating \$_____. Further, since amortization of these improvements was not made in certain prior years, and in other years was made in an amount equal to the net profit before amortization, we are of the opinion that the accumulated reserve for amortization should be increased by \$_____.

In our opinion, except for the matters referred to in the two preceding paragraphs, the accompanying balance sheet and statements of operating income and expenses and operating fund deficit present fairly the financial position of _____ College at June 30, 19__ and its income and expenses for the year then ended, in conformity with generally accepted accounting principles (or, with accounting practices generally followed by educational institutions), applied on a basis consistent with that of the preceding year.

(The above qualified opinion would be given under the assumption that the exceptions are not sufficiently material as to require a complete disclaimer of opinion.)

4. Report relating to additional schedules:

In our opinion, based upon our examination of financial statements of the President and Fellows of _____ College for the year ended June 30, 19____, the following schedules in the accompanying Treasurer's Investment Report, though not necessary for a fair presentation of the College's basic financial statements, present fairly the data shown therein:

Investment Income Collected and Disposition Thereof, year ended June 30, 19____ (page ____);

Analysis of General Investments Gain and Loss Account, year ended June 30, 19____ (page ____);

General Investments Summary, June 30, 19____ (page ____);

Special Investments Summary, June 30, 19____ (page ____);

General Investments, Cash, and Other Assets, Net, Held by Treasurer in Undivided Interests for Departments, June 30, 19____ (page ____).

Our examination of the financial statements of the College and the above-mentioned related schedules was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Municipalities

In 1951 the National Committee on Governmental Accounting published a manual entitled *Municipal Accounting and Auditing*. Numerous advisory committees, including one appointed by the American Institute of Certified Public Accountants, were consulted in its preparation. This volume is a revision and consolidation, made by the National Committee on Governmental Accounting, of several earlier publications which had received wide acceptance.

The manual includes a *Summary of Recommended Accounting Principles and Procedures*, fourteen in number, applicable to municipal accounting. Two of these are quoted below:

2. If legal and sound accounting provisions conflict, legal provisions must take precedence. It is, however, the finance officer's duty to seek changes in the law which will make such law in harmony with sound accounting principles.
9. Depreciation on general municipal fixed assets should not be computed unless cash for replacements can legally be set aside. De-

preciation on such assets may be computed for unit cost purposes even if cash for replacements cannot legally be set aside providing these depreciation charges are used for memorandum purposes only and are not reflected in the accounts.⁶

The National Committee's manual is intended to be more of an "ideal" than a statement of practices commonly followed; however, the long standing in accounting literature of the manual and its predecessors should receive careful consideration. It remains a matter of judgment for the independent auditor to form an opinion whether in any case the municipality's conformance or nonconformance with the manual's views seriously impairs the validity or usefulness of the municipality's financial statements.

Depreciation. In explanation of the stand taken on depreciation the manual states that:

1. A municipality, except in the case of utilities or other self-supporting enterprises, is not concerned with profits or losses.
2. Since the general fixed assets are not presumed to produce tax or other general revenues, charging current operations with depreciation has the effect of reducing revenues by costs to which they did not give rise, in violation of the principle of matching costs with their relevant revenues.
3. Unless cash can be set aside out of current revenues, depreciation charges cannot be included in the budget.⁷

Accrual Basis. The manual recommends that, to the extent applicable, the accrual basis or a slightly modified accrual basis be used. It comments that, even where the accrual basis is used, licenses are usually not taken into income until collected because licenses are usually not billed, and that ordinarily accrued interest expense is not recorded at the end of the fiscal year. The reason given is that the interest will be provided for in the budget of the following year, since it is not payable until the following year. If, therefore, it were included as an expenditure of the current year, the municipality would be violating the law which usually provides that no expenditure may be incurred until an appropriation has been made therefor. The manual concludes that a governmental unit is usually considered to

⁶ Pages 1-2.

⁷ Pages 126-127.

be on an accrual basis if it accrues the more important revenues and expenditures.⁸

Reporting Procedure. For municipalities (except utilities and other self-supporting units) which keep their accounts in accordance with the accounting methods recommended by the National Committee on Governmental Accounting, the opinion expressed by the independent auditor may relate to the fairness with which the statements present the financial position and results of operations in conformity with generally accepted accounting principles or (alternatively, but less desirably) in conformity with accounting practices generally used by municipalities. See page 45 for related discussion concerning use of alternative form.

The language of the standard short-form report, with any qualifications which may be necessary, is appropriate for utilities and other self-supporting units and any other municipal enterprises which keep their accounts in accordance with the accounting principles and standards applicable to commercial utilities and industrial organizations.

Accruals, especially accrued interest on outstanding indebtedness, are likely to involve substantial amounts. Disclosure should be made, preferably in the financial statements, of the omission of these accruals and of the practice regarding depreciation. Disclosure of unusual features resulting from compliance with charter or legal provisions is also necessary.

For accounts kept on the cash basis, the reporting standards described in the section relating to cash-basis statements apply (see pages 9 to 17).

Examples of Reports:

1. Report containing an explanatory paragraph which could, preferably, have appeared instead as a footnote on the statements:

We have examined the balance sheets of the various funds of the City of _____ as of December 31, 19__ and the related statements of revenues and expenses and fund equities for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

⁸ Pages 9-10.

In accordance with practices followed by municipalities, the accounts are kept on a modified accrual basis, under which the more important revenues and expenses are accrued, except accrued interest on outstanding indebtedness, which is payable from appropriations of the following year. Depreciation is not computed on property other than that employed in self-supporting activities.

In our opinion, the accompanying balance sheets and the related statements of revenues and expenses and fund equities present fairly the financial position of the various funds of the City of _____ at December 31, 19____, and the results of operations for the year then ended, in conformity with generally accepted accounting principles (or, with accounting practices generally followed by municipalities) applied on a basis consistent with that of the preceding year.

2. Report in a situation requiring reference to charter provisions where the accounting conforms to generally accepted accounting principles:

We have examined the balance sheet of the City of _____ Public Works Fund as of December 31, 19____ and 19____, and the related statements of operations and fund capital for the fiscal years then ended. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The administration of the Public Works Fund is governed by the general provisions of the Charter of the City of _____, as amended, and more particularly by Article _____ thereof. Section _____ of the Charter specifies, among other things, that taxes shall be levied annually to provide funds estimated to be necessary for the payment of bond obligations of the Department of Public Works and for reimbursement of the excess, if any, of the expenditures of the Department over its revenues. In view of this provision, specific reserves have not been established to provide for the payment of current or future amortization payments on the Department's bond obligations.

In our opinion, the accompanying balance sheets and statements of operations and fund capital present fairly the financial position of the City of _____ Public Works Fund at December 31, 19____ and December 31, 19____ and the results of its operations for the fiscal years then ended, in conformity with generally accepted

accounting principles (or, with accounting practices generally followed by municipalities) applied on a consistent basis during the two years.

3. Report containing amplifying comments on accounting procedures followed (financial statements do not disclose the policies regarding depreciation and accrued interest payable):

We have examined the balance sheets of the various funds of the City of _____ as of December 31, 19__ and the related statements of revenues and expenses and fund equities for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In accordance with established accounting practice for municipalities no provision has been made for depreciation of physical properties other than properties of the water fund, which is a self-supporting unit, nor is accrued interest on bonds payable taken into account.

In our opinion, the accompanying balance sheets and statements of revenues and expenses and fund equities present fairly the financial position of the various funds of the City of _____ at December 31, 19__, and the results of operations for the year then ended, in conformity with generally accepted accounting principles (or, with accounting practices used by municipalities) applied on a basis consistent with that of the preceding year.

4. Qualified report on a self-supporting unit:

We have examined the balance sheet of the City of _____, Department of _____, as of December 31, 19__ and the related statements of income and surplus for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Inventories of materials and supplies are stated at book amounts, supported by perpetual stock records. The department has curtailed its program which, prior to 19__, made provision for physical counts of substantially the entire inventory of materials and supplies over a twelve-month period; accordingly, only a minor

part of the inventories was physically checked during the current year. We test-counted selected items in the inventory and reconciled the quantities with those recorded in the perpetual inventory records as of December 31, 19__ in order to satisfy ourselves as to the substantial accuracy of the perpetual inventory records.

The accumulated provision for depreciation and retirement of depreciable physical property, in the aggregate, has been determined on a straight-line basis at composite rates applied to gross book values, in substantially the manner recommended by the Division Engineer based on a study made in 1907. Officials of the Division are of the opinion that the accumulated provision is excessive; however, as no engineering survey of the properties for this purpose has been made since 1907, no adjustment has been made.

In our opinion, except for the possible adjustment of the accumulated provision for depreciation and retirement of depreciable physical property which may be required as the result of an engineering survey, as described in the preceding paragraph, the accompanying balance sheet and statements of income and surplus present fairly the financial position of the City of _____, Department of _____, at December 31, 19__ and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

5. Report on examination of cash receipts and disbursements:

We have examined the statement of cash receipts and disbursements of the funds listed below of the Town of _____, _____, for the year ended May 31, 19__:

General Fund

Water Plant Fund

Water Bond and Interest Fund

Funding Bond and Interest Fund

Improvement Bond and Interest Fund

Building Bond and Interest Fund

Street Improvement Bond and Interest Fund

Town Recorder Fund

School Fund

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement of cash receipts and disbursements presents fairly the cash transactions of the funds listed above of the Town of _____, _____, for the year ended May 31, 19__.

Hospitals

A number of study groups have considered the accounting problems of hospitals and have recommended procedures designed to achieve uniformity in hospital accounting. One of the first classifications of accounts was made by the Commonwealth of Pennsylvania as the basis for quarterly payments to state-aided voluntary hospitals. Various private fund-raising agencies such as the Cleveland Hospital Council, the Duke Endowment, and the United Hospital Fund have established charts of accounts for their member institutions.⁹ In 1922 the American Hospital Association developed a manual on hospital accounting, which has undergone revision from time to time, the latest such revision having been issued in 1950.¹⁰

A basic difference exists between the financial purposes of hospitals and those of municipalities and institutions of higher education. Municipalities (except as to public utility and other self-supporting activities) are established by taxation for the purpose of providing a necessary public service at a cost distributed among taxpayers. Colleges and universities are established by benevolence and public funds for the purpose of making education available to all at a lowered price. Voluntary hospitals are created by benevolence and public funds to furnish service free or at nominal cost to those who cannot afford full payment, and on a cost or profit basis to the general public.

Developments since 1930 have magnified these differences. For many years hospital receipts from patients were secondary to philanthropy and taxation as a source of revenue, and ultimate cash collections were a small part of the values assigned to services. The years since 1930 have seen an important change in hospital revenue. The growth of the insurance corporations, particularly the Blue Cross Plan, the increase in block-grants of payments by government agencies for specific services, and the increased use of hospital facilities by the paying public generally are responsible for the change. Today, patient income is the primary source of revenue for voluntary hospitals,

⁹ C. Rufus Rorem, "Hospital Accounting," *How to Improve Accounting and Tax Service*, American Institute of Certified Public Accountants, New York, 1950.

¹⁰ *Handbook on Accounting Statistics and Business Office Procedures for Hospitals*, American Hospital Association, Chicago, 1950.

varying widely, however, among individual institutions. In some old, well-established hospitals, particularly those designed for the care of children, it may fall below 50 per cent of the total, but in some institutions where community support has not been developed, it may constitute practically the entire income.⁹

The increasing emphasis on income from patients has made clear the need for measures which are characteristic of the accounting for transactions entered into for profit. The Children's Bureau of the United States Department of Labor, the Bureau of Vocational Rehabilitation of the United States Department of Health, and the New York State Compensation Board have all recognized depreciation of buildings as an allowable item of cost in arriving at rates to be paid to hospitals for services rendered.¹¹ Various contracting agencies which purchase care on behalf of full-pay patients have asserted that they wish to pay the full costs of service, calculated on a business basis, including allowances for depreciation of plant and equipment.⁹

As a result of these developments, both the American Hospital Association¹⁰ and the United Hospital Fund of New York¹¹ have recommended that hospitals recognize depreciation of hospital buildings and equipment as an item of operating costs and that they consider this expense when arriving at rates to be charged for hospital services, even though the buildings and equipment may have been contributed originally and even though no cash or other funds are set aside to replace them. The systems which these organizations recommend also provide for use of the accrual basis. Their recommendations have resulted in the adoption of depreciation and accrual accounting by an appreciable number of hospitals.

It appears therefore that the American Hospital Association and the United Hospital Fund of New York have prescribed standards of accounting for voluntary hospitals which are acceptable to many hospitals and are in agreement, as to depreciation and accrual concepts, with principles of accounting generally accepted for the use of business enterprises organized for profit.

It should be noted that in this field an unusual situation exists. The recommendations relating to depreciation contained in the authoritative literature referred to above have not yet been accepted in practice by some nonprofit (nonproprietary) hospitals. Such hospitals generally take the position that depreciation is unnecessary since the hospital plant was derived from charitable subscriptions and that

¹¹ *Accounting Statistics and Business Office Procedures for Hospitals*, United Hospital Fund of New York, 1946, pages 37-38.

future additions or replacements thereof will be similarly provided. Since literature and practice are not, therefore, in complete harmony, it may be difficult for the independent auditor to conclude that the accounting principles in this area are so clearly defined as to require qualified opinions on statements which contain deviations from the recommended procedures. Accordingly, the independent auditor must exercise judgment in this respect in reporting upon the fairness of the financial statements of hospitals, thus allowing for reporting under alternative No. 2 mentioned below when adequate disclosures are made.

Reporting Procedure. Since the recommended accounting procedures for hospitals are essentially the same as those generally accepted for businesses organized for profit, opinions on financial statements of hospitals which follow the afore-mentioned manuals should employ the wording of the standard short-form report.

With respect to hospitals which have not accepted the recommended procedures relating to depreciation, but which in other respects keep their accounts on the accrual basis, it is believed that either of two methods of reporting may be used as appropriate:

1. The standard short-form report may be used with an explanatory paragraph regarding the departures from the recommended procedures and an appropriate qualification in the opinion paragraph. (When circumstances indicate that depreciation should be recorded.)
2. Disclosure may be made of the lack of provision for depreciation and an opinion expressed regarding fair presentation in conformity with the consistent application of the basis described. (When circumstances indicate that the omission of provision for depreciation is justified.)

In the case of hospitals organized for profit, as with similar business enterprises organized for profit, generally accepted auditing standards of reporting are applicable. For nonprofit hospitals which use the cash basis of accounting the reporting standards are those described in the section on cash basis statements.

Examples of Reports:

1. Report containing an explanatory paragraph regarding depreciation and a qualification in the opinion paragraph (the independent

auditor feels that a qualification is needed in this particular case and in case No. 2):

We have examined the balance sheet of _____ Hospital as of December 31, 19____ and the related statements of income and expenses and of hospital equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The hospital keeps its accounts in general on the accrual basis, except that it does not provide for depreciation of property other than a comparatively small amount of property used in auxiliary services. If full depreciation had been computed, the additional depreciation would have totaled \$_____, thereby reducing net income from operations accordingly, and accumulated depreciation would have amounted to \$_____.

With this exception, in our opinion the accompanying statements present fairly the financial position of _____ Hospital at December 31, 19____ and results of operations for the year then ended, in conformity with generally accepted accounting principles, applied on a basis consistent with that of the preceding year.

2. If the information given in the middle paragraph of the preceding illustration had been disclosed in a note to the financial statements (the preferable procedure), the middle paragraph could have been omitted and the opinion stated as follows:

In our opinion, except for the omission of provision for depreciation of property other than that employed in auxiliary services, as described in Note ____ to the financial statements, the accompanying statements present fairly the financial position of _____ Memorial Hospital at December 31, 19____ and the results of operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

3. When a hospital omits depreciation of hospital plant, and the independent auditor feels there is justification for this practice (as, for example, when the hospital is a government supported institution or has consistently relied on charitable sources for capital improvements), the following report may be used (the information given in the

middle paragraph may be furnished in the form of a footnote):

We have examined the accompanying financial statements of _____ Memorial Hospital as of September 30, 19__ and for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In accordance with practices common to hospitals which rely upon (government support, charitable sources, etc.) for capital improvement, the hospital keeps its accounts on the accrual basis and does not provide for depreciation of its basic hospital plant.

In our opinion, the accompanying financial statements present fairly the financial position of _____ Memorial Hospital at September 30, 19__ and the results of operations for the year then ended, in conformity with the above-mentioned basis, which is consistent with that of the preceding year.

4. Qualified report (excessive provision for uncollectible accounts):

We have examined the balance sheet of _____ Hospital, New York, as of December 31, 19__ and the related statement of income and summary of changes in funds for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The hospital provides reserves in full for accounts due from patients other than in-house patients and those whose accounts are payable from the proceeds of insurance. On the basis of collection experience over the past five years, it appears that the reserve is overstated and current fund assets understated by \$_____ and that operating income for the year is understated (overstated) by \$_____.

In our opinion, with the foregoing exception, the accompanying balance sheet and statement of income and summary of changes in funds present fairly the financial position of _____ Hospital at December 31, 19__ and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

SECTION III

Reports on Certain Aspects of Financial Statements

It is not unusual for the independent certified public accountant to be requested to make an examination of a particular limited nature such as the determination of rentals, profit-sharing bonuses, etc. Engagements of this type, being of a special report nature, are summarized in Paragraph 3c(1) of Statement on Auditing Procedure No. 28:

Reports prepared for limited purposes, such as:

Reports that relate only to certain aspects of financial statements. These reports may include reports, sometimes in letter form, relating to special studies, to compliance with certain provisions of bond indentures, or to the determination of the amounts of rentals, royalties, profit-sharing bonuses and the like.

The committee on auditing procedure recommended the following application of the four standards of reporting to this category of special reports:

Reporting standard No. 1 ____ an opinion as to conformity of financial statements with generally accepted principles of accounting (Paragraphs 8 and 15):

8. Although there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations, such as in reports upon compliance with certain provisions of bond indentures, the committee is of the opinion that the requirement of the first standard of reporting

does not apply to statements which do not purport to set forth financial position and results of operations. . . .

15. Special reports in which incomplete financial presentations or no financial presentations are made (e.g., calculations of royalties, profit-sharing bonuses, rentals, etc.) should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the auditor's opinion, it is presented fairly on that basis. As indicated in paragraph 8 there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations; such occasions usually arise when there is interest in establishing that a part only of the financial statements is in conformity with generally accepted accounting principles, such as the determination of "working capital" under a bond indenture. There may be occasions, in reports containing an expression of an opinion on the fairness with which financial statements present financial position and results of operations, where the auditor also expresses an opinion as to the adequacy or reasonableness of specific accounts, such as those for the allowance for doubtful accounts receivable or the liability for income taxes. The usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements taken as a whole and not necessarily with respect to specific accounts. Accordingly, it is generally undesirable for an auditor to render a separate opinion on a specific account, but where the situation is such that he considers it appropriate to do so, he should be cognizant of the added responsibility he may thereby be assuming and the possible necessity of extending the scope of his examination.

The last three reporting standards are applicable as summarized under "Cash or Other Incomplete Accounting Bases" on pages 9-17.

Reports Relating to Compliance with Provisions Contained in Bond Indentures and Various Loan Agreements

Bond indentures and certain types of loan agreements contain a variety of covenants by the borrowers relating to such matters as, for example, payments into sinking funds, retirement of principal directly or through operation of sinking funds, payment of interest, maintenance of current position, restriction of dividend payments, and investment or deposit of the proceeds of property sold. They also usually contain an agreement by the borrower to furnish annual financial statements which have been examined by independent certified public accountants. Additional schedules are sometimes required and the classification of certain assets, especially current assets, and

of certain types of income and expenses, for purposes of determining compliance, is sometimes specified.

In addition to receiving the audited financial statements, the trustees or lenders may require assurance from the independent auditors that borrowers have complied with such clauses of the agreement as relate to matters coming within the independent auditor's province.

The audit report requires no special treatment unless the agreement calls for supplemental schedules or provides that certain assets, liabilities, income, or expenses shall have special treatment in the financial statements. However, its issuance may entail an examination of greater scope than would be called for if the specific items to be reported upon were simply a part of the over-all financial statements. The supplemental schedules usually require mention in the opinion. Classifications which deviate from those usually used in the company's financial statements call for amplification of captions such as, "Net income as defined in the indenture . . ." or "Current assets as defined in the indenture. . . ." If the treatment or classifications required to be used in financial statements are at variance with sound accounting concepts, the accountant should qualify his opinion and state what, in his opinion, the treatment or classification should have been.

Compliance with or defaults in the special covenants may be made the subject of a special letter report or may be covered in one or more paragraphs in the short-form report which accompanies the financial statements. Below are examples of appropriate treatment:

1. Compliance covered in short-form report accompanying financial statements (some independent auditors prefer to place the middle paragraph last):

We have examined the balance sheet of _____ Company and the consolidated balance sheet of _____ Company and its consolidated subsidiaries as of December 31, 19____ and the related statements of net earnings and earnings retained for use in the business for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In making our examination we obtained no knowledge of any default by the company in the fulfillment of any of the terms, covenants, provisions, or conditions of Sections 4.14 to 4.19, inclusive,

of the indentures dated as of August 1, 19____, as amended, and as of October 1, 19____, relating to the sinking fund debenture issues.

In our opinion, the accompanying statements present fairly the financial position of _____ Company, the consolidated financial position of the company and its consolidated subsidiaries at December 31, 19____, and the results of their operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

2. Compliance covered in separate report:¹

We have examined the balance sheet of _____ Corporation as of October 31, 19____ and the related statements of additional paid-in capital, net earnings, and earnings retained for use in the business for the year then ended, as reported to you on December 15, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In making our examination we obtained no knowledge of any default by the company in the observation, performance, or fulfillment of any of the terms, covenants, provisions, or conditions contained in the loan agreement with an insurance company dated _____ and in the note executed thereunder. However, it should be understood that our examination was not directed primarily toward obtaining such knowledge.

3. Compliance and defaults covered in separate report in letter form:

We have examined your financial statements for the year ended December 31, 19____ and have reported thereon under date of March 2, 19____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

¹ The foregoing opinion covers *all* covenants in the agreement, as required. Independent auditors frequently include the last sentence of the illustration when such covenants cover broad operational activities not always reviewed in the ordinary examination, or the making of legal interpretations which they are not qualified to make.

In connection with our examination we have obtained no knowledge of any default by you under the provisions of Paragraphs 12, 13, 14 or 17 of the mortgage agreement dated September 1, 1941, between you as mortgagor and _____ Insurance Company as mortgagee. However, our examination disclosed violations of the provisions of Paragraphs 15, 16 and 20 of the mortgage agreement, as set forth below:

In violation of Paragraph 15, the current assets of the company as of December 31, 19__ were less than ____% of current liabilities. The mortgagee, under date of December 1, 19__, has waived its right to declare a default under the mortgage by reason of this violation, such waiver, however, not constituting a precedent as to any future defaults.

During the year ended December 31, 19__, the company, in connection with the financing of its defense production contracts, entered into two loan agreements: (1) a temporary construction loan covering the major part of the cost of required new building facilities and (2) a five-year mortgage loan agreement to replace the temporary construction loan upon completion of the new facilities. The creation of these agreements constituted a violation of the provisions of Paragraph 16 of the mortgage agreement. However, the mortgagee is cognizant of this violation by virtue of being a party to a certain agreement dated December 1, 19__, between the company, _____ Insurance Company, and _____ Trust Company.

Certain buildings were demolished in connection with the construction of new defense facilities without obtaining prior written consent from the mortgagee as required under Paragraph 20 of the mortgage agreement. The mortgagee subsequently gave its consent to these demolitions.

4. Report on financial statements prepared in accordance with classifications contained in the indenture:

We have examined the accompanying balance sheet of _____ Corporation as of June 30, 19__ and the related statement of income and retained earnings for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

These statements, which are for the use of the trustee under the indenture securing the company's first mortgage 50 year bonds dated January 15, 1922, have been prepared in accordance with classifications prescribed in the indenture, which require that cash surrender value of insurance policies on the lives of officers be included in current assets. Under accounting principles now generally accepted, the cash surrender value of life insurance policies is usually excluded from current assets.

With this exception, in our opinion, the accompanying statements present fairly the financial position of _____ Corporation at June 30, 19___ and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Letters for Information of Underwriters in Connection with SEC Registrations*

Investment bankers who have agreed to underwrite issues of securities which have been registered with the Securities and Exchange Commission require certain assurances from the independent certified public accountants who examine the financial statements and schedules reproduced in the Registration Statement. These assurances usually are as follows:

1. That the accountants are in fact independent, as that term is defined in SEC regulations.
2. That the financial statements and schedules and the summaries of earnings as to which the accountants have expressed an opinion comply as to form in all material respects with the applicable accounting requirements of the rules, regulations, and instructions of the SEC relating to financial statements.
3. That the accountant knows of no material adverse changes in the financial condition of the company since the date of the certified balance sheet (other than that which may be disclosed in the Registration Statement).
4. That a general review of uncertified financial statements and schedules included in the registration statement, supplemented

*For a complete discussion of this subject, see *SEC Accounting Practice and Procedure*, by L. H. Rappaport, Chapters 6 and 7.

by pertinent inquiries, disclosed no information which would require modification of those statements.

Reports on these matters are usually in letter form.

The assertion as to independence, since it relates directly to the accountants, does not need the qualifying words, "in our opinion."

Conformity of the certified statements with pertinent SEC regulations is a matter of opinion and should be expressed as such.

The assertions regarding post-balance-sheet events and the financial statements for the unaudited period are based upon a limited review, without audit, for the related periods and upon inquiries addressed to responsible officers. The wording of the report should make clear the nature of this limited review and can obviously be no more than an assertion to the effect that no knowledge was obtained which would require modification or amplification of the disclosures made. Since the letter is not based on an audit, its use should be restricted to persons familiar with its limitations and, to avoid possible misinterpretation, should not be circulated to the general public or made a part of the Registration Statement.**

All these matters may be covered in one letter or may be made the subject of individual letters. The letter or letters are usually addressed to the company. If requested, the independent auditor may address them to the underwriters or purchasers or, where these are numerous, to their representatives, provided the company authorizes the independent auditor to furnish such letters directly to underwriters.

Letters covering items 3 and 4 should stipulate, for the reason given above, that they are not to be referred to in the Registration Statement or in connection with the sale of the securities.

Examples of Reports:

1. Letter combining all features addressed to the underwriters at the request of the client:

_____ Underwriters,	} representatives of the several under-	
and		writers constituting the underwriting
_____ Underwriters		group formed by an underwriting
	} agreement with _____ Com-	
	} pany dated _____.	

**SEC Accounting Series Release No. 62 prohibits the use of an accountant's name in connection with financial statements unless he has made an examination of those statements in accordance with generally accepted auditing standards.

Dear Sirs:

We are independent certified public accountants as that term is defined in the Securities Act of 1933 and the rules and regulations of the Securities and Exchange Commission under that Act.

Under date of June 7, 19__ we reported on our examination of the financial statements and supporting schedules of _____ Company, Inc., for the three years ended December 31, 19__, and summary of earnings for the five years ended December 31, 19__, forming part of the Registration Statement, as amended, filed by that company with the Securities and Exchange Commission under the Securities Act of 1933. In our opinion, these financial statements, schedules, and summary of earnings comply as to form in all material respects with the pertinent published accounting requirements of the Securities Act of 1933 and the applicable published rules, regulations, and instructions of the Commission.

We have not made a similar examination of the accounts of the company after December 31, 19__, but have made a general review of results of operations from January 1, 19__ to June 30, 19__ (the latest date as of which the general accounts were posted) and have made inquiries of officers and employees of the company responsible for accounting matters. Such limited review and inquiries did not bring to our attention any material adverse changes in the financial condition of the company during that period, other than as set forth in the Registration Statement.

We have made a limited review of the uncertified financial statements and schedules for the four months ended April 30, 19__ and the preceding comparable four months ended April 30, 19__ which are included in the Prospectus and the Registration Statement. Our review did not constitute an examination made in accordance with generally accepted auditing standards, but was a general review supplemented by inquiries addressed to officers and employees of the company responsible for accounting matters. Such limited review and inquiries disclosed no information which would require modification of the uncertified financial statements and schedules.

It is understood that this letter is not to be quoted or referred to, in whole or in part, in the Registration Statement or Prospectus or in connection with the sale of securities, but copies may be furnished to members of the underwriting group.

2. Separate letter relating to subsequent events:

_____ Corporation,

Dear Sirs:

We have made an examination of the financial statements of _____ Corporation and subsidiaries for the five years ended December 31, 19____. Our opinion relating to the financial statements and schedules for the three years and summary of earnings for the five years ended December 31, 19____, is included in a Registration Statement (may be identified here) filed with the Securities and Exchange Commission.

We have not made an examination of any of the accounts or transactions after December 31, 19____. However, at your request we have made a limited review of the available subsequent interim financial statements and have made inquiries of and have had discussions with certain officers and employees responsible for accounting matters as to transactions and events after December 31, 19____. Interim financial statements were available only to April 30, 19____, and the general records were completely posted only to that date. Our review and inquiries did not bring to our attention any material adverse changes in the financial position of the company during the period from December 31, 19____ to the date of this letter other than (a) changes resulting from the ordinary and regular conduct of the business and (b) changes mentioned or contemplated in the company's Registration Statement, as amended.

It is understood that this letter is solely for the information of the corporation but copies may be furnished to the underwriters, and is not to be mentioned in the Registration Statement or any amendments thereof or in the Prospectus or in connection with the sale of the securities.

3. Separate letter relating to uncertified financial statements:

_____ Company, Inc.

Gentlemen:

We have made a limited review of the uncertified financial statements and schedules of _____ Company, Inc., for the four months ended October 31, 19____, and the preceding comparable four months ended October 31, 19____ included in a Registration Statement filed by you with the Securities and Exchange Commission. Our review did not constitute an examination of the accounts in accordance with generally accepted auditing standards, but consisted of inquiries made of officers and employees responsible for

accounting matters and comparison of the data contained in the statements and schedules with the general accounts maintained in New York and with similar data for prior periods. Our inquiries and review did not bring to light any inconsistencies with the generally accepted accounting principles and practices followed in the certified financial statements and schedules included in the Registration Statement, except as explained in Notes 2 and 5, nor have we reason to believe that they do not present fairly the information shown.

It is understood that this letter is solely for the information of the company and underwriters and is not to be quoted or referred to, in whole or in part, in the Registration Statement or in connection with the sale of the securities.

4. Letter covering review of unaudited interim financial statements:

_____ Company

Dear Sirs:

We previously submitted our reports dated _____ upon our examination of the financial statements and supporting schedules of (name of company) and the consolidated financial statements and supporting schedules of that company and its subsidiaries as of (date) and for the years _____, _____, and _____, and the summary of earnings for the years _____ to _____, inclusive. The afore-mentioned statements, supporting schedules, and summary of earnings, together with said reports, are included in Registration Statement No. _____, filed by (name of company) with the Securities and Exchange Commission.

Pursuant to your request, we have reviewed and made a limited investigation, but not an audit, of the financial statements and supporting schedules of (name of company) and the consolidated financial statements and supporting schedules of that company and its subsidiaries as of (interim date) and for the (interim period) months then ended, and the summary of earnings for the (interim periods) ended (date) and (date), which statements, schedules, and summary are also included in the above-mentioned Registration Statement. Such statements, schedules, and summary were checked in detail by us with the face of the general accounts of the respective companies and were compared with similar data for prior periods. We also made inquiries of officers and other employees of the companies responsible for accounting matters as to the consistency of accounting procedures and

as to the existence and disclosure of any material contingent liabilities. Our review and investigation did not reveal to us any information which gives us reason to believe that the afore-mentioned financial statements and summary do not fairly present the financial position at (interim date) and results of operations for the (interim periods) ended (date) and (date) of (name of company) and of that company and its subsidiaries consolidated in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding fiscal year(s).

Insofar as we have determined from our limited review and investigation, the financial statements, supporting schedules, and summary referred to in the preceding paragraph appear to conform in all material respects with the pertinent accounting requirements of the Securities Act of 1933 and the pertinent published rules, regulations, and instructions of the Securities and Exchange Commission.

It is understood that this letter is not to be reproduced, in whole or in part, or be referred to in the Registration Statement, or in any amendment thereto or in the related Prospectus, or in any literature used in connection with the offering of securities covered by the afore-mentioned Registration Statement, but such information may be furnished to members of the underwriting group.

5. Letter relating to independence of auditors, conformity of certified financial statements with relevant SEC requirements, and subsequent events (addressed to representatives of underwriting group):

_____ Inc.

Dear Sirs:

We have made an examination of the financial statements and schedules of X Company (the Company) as of December 31, 1959 and for the year then ended, and the summary of earnings of the Company for the five years then ended, and our opinion and consent with respect to all of the foregoing are included in a Registration Statement (No. 2-), as amended, filed by the Company under the Securities Act of 1933 with the Securities and Exchange Commission, and in the Prospectus constituting a part of such Registration Statement.

We are independent public accountants within the meaning of the Securities Act of 1933 and the Rules and Regulations of the Securities and Exchange Commission thereunder.

In our opinion, the financial statements and schedules and the summary of earnings, as of December 31, 1959 and for the five years

then ended, examined by us and included in the Registration Statement, in the form in which it became effective, and in the Prospectus constituting a part thereof, conform in all material respects with the relevant requirements of the Securities Act of 1933 and the applicable Rules and Regulations of the Securities and Exchange Commission thereunder, and with the instructions relating to financial statements for registration statements on Form S-1.

We have not made an examination of any financial statements or related tests of any accounting records of the Company as of any date or for any period subsequent to December 31, 1959, and therefore we are not in a position to express, and do not express, an opinion on any such financial statements. However, with respect to the period from December 31, 1959 to April 2, 1960, at the Company's request, we have done the following:

- (1) Read interim monthly financial statements of the Company covering the period from December 31, 1959 to February 29, 1960, the latter date being the latest date to which financial statements were made available to us on April 2, 1960;
- (2) Read the minutes of the meetings of the Stockholders and the Board of Directors of the Company held during the period from December 31, 1959 to April 2, 1960;
- (3) Consulted with officers of the Company responsible for financial and accounting matters with respect to the period from December 31, 1959 to April 2, 1960, especially as to whether there was any change in the capital stock or funded debt of the Company, or any material adverse change in the financial position, or results of operations of the Company, except as set forth in or contemplated by the Registration Statement in the form in which it became effective and the Prospectus constituting a part thereof.

The foregoing procedures and inquiries, which do not constitute an examination made in accordance with generally accepted auditing standards and which would not necessarily reveal all adverse changes in the financial position, or results of operations of the Company, did not bring anything to our attention, and nothing came to our attention, which causes us to believe that during the period from December 31, 1959 to April 2, 1960 there has

been any change in the capital stock or funded debt of the Company, or any material adverse change in the financial position or results of operations of the Company, except as set forth in or contemplated by the Registration Statement in the form in which it became effective and the Prospectus constituting a part thereof.

This letter is solely for the information of the Underwriters and is not to be referred to in whole or in part in the Registration Statement, Prospectus, or any other similar document, or quoted by excerpt or reference outside the underwriting group in connection with the sale of securities except for any reference to it in the underwriting agreement or in any list of closing documents.

Other Instances

Certified public accountants are called upon to render a variety of reports relating to the compliance of certain statements or certain transactions with the terms of various types of agreements.

These reports should make reference to generally accepted auditing standards and to auditing tests and procedures. They should clearly identify the agreements to which they relate and should describe any significant assumptions which were necessary and were not specifically covered in the agreements.

The opinions expressed usually relate to compliance with terms of the agreement, rather than to conformity with generally accepted accounting principles, since matters of accounting judgment are not usually involved. They should make clear what any statements submitted purport to present and whether or not they present that information fairly. Where, however, financial statements are submitted which conform to generally accepted accounting principles and standards of disclosure, the wording of the standard short-form report is appropriate.

Obviously, it is impossible to submit examples of all situations. The examples which follow consist of reports suitable in some of the situations encountered in practice.

Royalty Agreements:

I. Report relating to royalties payable under royalty agreements:

_____ Company

Gentlemen:

We have examined copies of the monthly production and royalty reports rendered by you to the United States Department of In-

terior, Geological Survey, for the year ended January 31, 19____, under your Federal lease contracts known as _____. We have previously reported upon our examination of the financial statements of the company for the year. Our examination of the production and royalty reports was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The lease contracts applicable to all production contain the following undertaking by the company: "to pay the lessor for the output of the leased deposits, a royalty of _____ per cent of the gross value thereof at the point of shipment to market. . . ." In connection with the original leases an official ruling stated: "The point of shipment to market is at the refinery on refined or mixed products and at the grinding plant on ground crude products."

Royalties have been reported and paid by the company on the basis of sales after deducting freight, bag charges, and, for ground crude products only, tramroad hauling expense. Sales so adjusted are allocated monthly to Federal leases and other leases and interests on the basis of the production of each month.

In our opinion, with the explanation in the preceding paragraph, royalties for the year ended January 31, 19____ under the Federal leases referred to above are fairly stated in the accompanying summary.

2. Report relating to royalties payable:

_____ Corporation,
and
_____ Company, Inc:

We have made an examination of the accounts relating to engine production of the _____ Division of _____ Company, Inc., for the period from _____ to _____. Our examination was made for the purpose of determining the number of engines produced on which royalties were payable under the terms of a license agreement dated _____ between _____ Company, Inc., and _____ Corporation. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The royalty payments made by _____ Company, Inc.,

during the period were based on production totals after deducting production returns which were scrapped, but without deducting field returns which were scrapped even though the field returns were replaced with new engines without charge to the customer. This treatment is consistent with that followed in prior years.

In our opinion, the accompanying royalty statement fairly sets forth the number of engines produced by _____ Company, Inc., during the period from _____ to _____ and the amount of royalties applicable thereto, on the basis explained in the preceding paragraph, under the terms of the license agreement dated _____.

Pension and Profit-Sharing Plans:

1. Report relating to determination of amount of contribution payable under profit-sharing plan:

Board of Administration,
_____ Corporation Profit-Sharing Retirement Plan
for Salaried Employees:

In connection with our examination of the financial statements of _____ Corporation for the year ended September 30, 19____, which we reported upon under date of _____, we tested payroll and certain other records of the company for the purpose of determining that the amount of the contribution to the Profit-Sharing Retirement Plan for Salaried Employees for the year was fairly computed in accordance with the provisions of Section 2 of Article IV of the Plan as amended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the contribution required for the year is fairly computed in accordance with the terms of the plan as follows: . . .

If the amount had been determined in accordance with the formula provided in Paragraphs (c) and (d) of Section 2, Article IV, it would have amounted to \$_____, as follows: . . .

However, as this amount is greater than 15 per cent of the compensation of the employees included in the Plan, after elimination of compensation to individual employees in excess of \$_____ a year, the method of computation shown in the next preceding paragraph, which shows a required contribution of \$_____ for the year ended September 30, 19____, is applicable.

2. Long-form report relating to contributions to a pension plan and to the expense of the plan:

Board of Administration,

_____ Corporation Pension and Retirement Income

Trust Fund for Supervisory, Office and Technical Employees:

We have examined certain records of _____ Corporation and subsidiary companies relative to the contributions required to be made to the _____ Corporation Pension and Retirement Income Trust Fund for Supervisory, Office and Technical Employees, and to expenses incurred in administration of the Plan, for the year ended November 30, 19____, under the terms of the Pension and Retirement Income Agreement. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Contributions to Trust Fund. The Pension and Retirement Income Agreement requires that the companies deposit with the trustee an amount representing five and one-half cents for each hour worked, including eight hours for each paid holiday and forty hours for each week of vacation for which compensation is paid.

Our examination shows that during the year ended November 30, 19____ the companies made contributions to the trust fund in accordance with the terms of the agreement, except for minor mechanical errors totaling, for all plants, \$_____. Adjustments of errors of this type are normally made in the following year. Contributions made in 19____ covered a similar adjustment for errors made in the preceding year, and totaled \$_____, as follows: . . .

In computing contributions for the year, each holiday was counted as eight hours or as the actual hours worked if more than eight, and vacation payments in lieu of time off were counted as forty hours for each week's salary or wages paid therefor.

Our examination included summarization of hours worked as shown by payroll records of the plants and tests of the correctness of the hours shown for selected periods by reference to time cards or other underlying evidence. Special attention was given to periods involving holidays and vacation payments.

Cost of Administration of Fund. Direct expenses incurred by the participating companies which could be identified as relating to the

administration of the plan for the year ended November 30, 19__ and the expenses for the year disbursed directly from the trust fund are summarized as follows: . . .

In our audit of these costs we examined payroll and employment records in support of labor and related charges and inspected invoices or supplies requisitions for services and supplies relating to pension activities. In support of administration expenses disbursed directly from the trust fund we inspected invoices or other supporting evidence.

Opinion. In our opinion, the accompanying statements of contributions and costs of pension plan administration present fairly the adjusted contributions required to be made to the trust fund and the related expenses incurred by the participating corporations applicable to the administration of the _____ Corporation Pension and Retirement Income Trust Fund for Supervisory, Office and Technical Employees for the year ended November 30, 19__.

3. Report on the financial statements of a retirement board (accounts kept on the accrual basis). (The disclosure in the middle paragraph is preferably made in a note to the financial statements.):

To the Retirement Board of Employees' Retirement Plan of _____ Company:

We have examined the statement of financial condition of the Retirement Board of Employees' Retirement Plan of _____ Company as at December 31, 19__ and the related summary of income and expenses for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The contributions by participating companies for prior services and for current services and the transfers from accumulation account and from members' account to retirement reserve account were in amounts recommended by the consulting actuary.

In our opinion, the accompanying statements present fairly the financial position of the Retirement Board of Employees' Retirement Plan of _____ Company at December 31, 19__, and the results of its operations for the year then ended, in conformity with

the rules and regulations of the plan and in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

4. Long-form report on the financial statements of a retirement fund, containing explanatory material (accounts kept on the accrual basis):

Board of Trustees,

_____ Retirement Fund:

We have examined the statement of financial condition of _____ Retirement Fund as of December 31, 19__ and the related statement of income and expenses and fund equity for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

The Retirement Trust Agreement provides for the creation of a fund for the payment of specified benefits to eligible employees of _____ Corporation and its subsidiaries. Benefits are payable at retirement upon reaching retirement age, or at an earlier date in case of permanent incapacity, and are based upon varying rates per month for each year of credited service up to thirty years. In the event of termination of the agreement, the fund is to be allocated in a manner which will provide for payment of benefits to eligible employees. The allocation may be accomplished by continuance of the fund or by purchase of annuity contracts.

The plan is noncontributory, being financed entirely by the corporation and its subsidiaries. The companies are required to make contributions in amounts determined by an independent actuary to provide the benefits specified under the plan together with reasonable costs of administration, but not in excess of five cents for each hour for which the participants received compensation from the companies. In the absence of an actuarial determination contributions were made at the maximum rate, five cents an hour, to September 30, 19__. The actuarial study subsequently made as of that date by _____ disclosed that contributions at the rate of four cents an hour are adequate to maintain the fund on a sound basis, and that the contributions to September 30, 19__ were therefore approximately \$_____ more than were needed. At four cents an hour the contribution applicable to the period from October 1 to December 31, 19__ amounted to approximately \$_____. This amount was not, however, paid into the fund but

was offset in part against the excess contributions, except as to one subsidiary which joined the plan only recently and for which no excess contributions had been made. At December 31, 19____, an excess of \$_____ remained to be applied against contributions applicable to 19____.

The contributions received by the fund were reconciled with payments shown by the records of the contributing companies. We reviewed the methods used in computing these amounts, determined that contributions were made for each applicable payroll during the year, and tested the conformity of the computation with the provisions of the agreement.

We also reviewed the methods of determining payments to beneficiaries and examined supporting data to an extent sufficient to afford reasonable assurance that expenditures were made for authorized purposes.

Investments and cash segregated for future investment were confirmed to us by the holder, the _____ Trust Company, the designated investment agency of the fund.

The accounts of the fund are kept on an accrual basis, except that amounts payable to participants for benefits are recorded only when the payments are made.

In our opinion, the accompanying statement of financial condition and of income and expenses and fund equity present fairly the financial position of _____ Retirement Fund at December 31, 19____ and the results of its operations for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

5. Letter report relating to determination of the amount of income to be realized before an extra compensation plan becomes operative:

_____ Corporation:

As requested, we have reviewed the terms of your Profit-Sharing Retirement Plan dated _____ and have prepared the following computation for the purpose of determining the maximum amount of earnings realizable during the year ended February 28, 19____, before the profit-sharing features of the plan become operative:

Ledger balances at (date) as shown in the
balance sheet accompanying our report of
examination dated (date):

Capital stock	\$
Capital surplus (amounts received for capital stock in excess of par value)	
Earned surplus (earnings retained for use in the business)	
Surplus reserves	
Total	\$ <u> </u>
Maximum earnings before plan becomes oper- ative — 12% of the above	\$ <u> </u>

In our opinion, the aforementioned schedule presents fairly the maximum amount of earnings realizable during the year ended December 31, 19____, before profit-sharing features are applicable under the terms of the Profit-Sharing Retirement Plan dated _____.

Lease Agreements:

1. Report relating to determination of the amount of sales of a lessee for purposes of computation of rental:

Board of Directors,
_____ Company, Inc.:

We have examined certain of the accounting records of _____ Stores Corporation for the year ended October 31, 19____, for the purpose of determining the amount of gross sales during 19____ at its Main Street store as defined in the agreement dated _____ covering the lease of property by _____ Company, Inc., to _____ Stores Corporation. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We examined the weekly cash reports submitted by the store manager for the year. These reports show information as to gross sales, cash register readings, sales taxes imposed by governmental authorities, payments made by store managers, returns and allowances, discounts granted, and other information. We compared the monthly summarizations of sales in these reports with the general ledger and for five days in each month we compared the daily cash net receipts shown in the weekly cash reports with the corporation's bank statements.

In our opinion, the gross sales of _____ Stores Cor-

poration at its Main Street Store for the year ended October 31, 19__ as defined in the lease are fairly stated at \$_____.

2. Report relating to examination of sales of a lessee for the purpose of determining rental due under a lease agreement:

_____ Corporation:

We have examined certain of the accounting records of _____, Inc., 1 Main Street, _____, _____, for the year ended December 31, 19__, for the purpose of determining the amount of net sales during the year as defined in the lease agreement dated _____, and the amount of rent payable for the year under the terms of the lease. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

We reviewed the monthly sales summaries and found their totals to be in agreement with the amounts shown by the general ledger. We also reconciled these amounts with the sales reported for state sales tax and Federal income tax purposes. For one test month we accounted for the block of consecutively numbered invoices written and traced the amounts of recorded sales to copies of the related invoices.

Net sales recorded in the general ledger exceeded sales reported to _____ Corporation by \$_____, explained by the tenant as sales at cost to other dealers under reciprocity agreements. These are not reported as sales to the State Department of Revenue and the tenant claims that under the agreement these sales are excludable from the computation of rentals. If they were included in the computation of rentals, the rental for the year would be increased by \$_____.

In our opinion, except for any possible required adjustment with regard to the omitted sales referred to in the preceding paragraph, the net sales of _____, Inc., for the year ended December 31, 19__ are fairly stated at \$_____ and the related rental payable by _____, Inc., under the lease agreement dated _____ is fairly stated at \$_____.

Sinking Fund Contributions:

1. Report relating to determination of net earnings applicable to computation of a sinking fund contribution:

Board of Directors,
_____ Corporation:

We have examined the statement of consolidated net earnings of _____ Corporation and subsidiaries for the year ended December 31, 19__ applicable to the computation of the 19__ sinking fund contribution to be made by _____ Corporation, as defined in Section 2 of Article 1 of the Indenture dated January 1, 19__ of _____ Corporation to _____ Trust Company, Trustee, securing \$1 million principal amount of convertible debentures due January 1, 19__. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, this statement presents fairly the consolidated net earnings of _____ Corporation and subsidiaries for the year ended December 31, 19__, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year, and as defined in Section 2 of Article 1 of the Indenture, for purposes of computation of the 19__ sinking fund contribution thereunder.

Income Available for Dividends:

1. Report on determination of income available for dividends:

_____ Company, Inc.:

We have examined the consolidated balance sheet of _____ Company, Inc., and its wholly owned subsidiaries as of August 31, 19__ and the related statement of consolidated income and retained earnings for the year then ended, and have reported thereon under date of _____. In connection therewith, we also examined the accompanying computation of the amount available for payment of dividends.

Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying computation of the amount available at August 31, 19__ for payment of dividends on the company's common stock, other than dividends payable in such stock, has been made in accordance with the provisions of Article

1, Section 3, of the Indenture of Trust and Mortgage dated as of January 1, 19____, underlying the \$_____ face amount of convertible 4½ per cent mortgage bonds due July 1, 19____.

Report on Contract Guarantees:

1. Report for filing with Export-Import Bank relating to guarantees under contract:

Board of Directors,

_____ Corporation:

In connection with our examinations of the financial statements of _____ Corporation and of _____ Company, Ltd. (a wholly owned British subsidiary of _____ Corporation) for the year ended December 31, 19____, on which we reported under date of _____, we have examined the accompanying Progress Reports filed by _____ Corporation with the Export-Import Bank of Washington, under Contract of Guaranty No. 2, dated as of January 1, 19____, covering the six month periods ended June 30, 19____, and December 31, 19____. Our examinations were made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying Progress Reports present fairly the amounts of "investment" made by _____ Corporation in _____ Company, Ltd., and all amounts received as "receipts from the investment" during those periods, as those terms are defined in the Contract of Guaranty. All other statements made in these Progress Reports are, in our opinion, on the basis of our examinations, fair representations.

SECTION IV

Prescribed Form Reports

The final classification of special reports as noted in Paragraph 3c(2) of Statement on Auditing Procedure No. 28 includes reports prepared for limited purposes, such as:

Reports that are filed with various agencies on prescribed forms which provide a uniform statement presentation, in some cases with a preworded opinion or authentication. These reports may include reports prepared for filing with various governmental authorities or with credit and similar agencies.

The four generally accepted auditing standards of reporting are applicable to financial statements filed on prescribed forms. Therefore, the problem is one of adapting the prescribed form to conform to professional standards. Paragraph 16 discusses this problem further as follows:

16. Statements prepared on printed forms designed by the authorities with which they are to be filed may require inappropriate classifications or other similar procedures that, in the auditor's opinion, do not fairly present the financial position or results of operations of the particular company filing the statements, even though they purport to do so. Also, such forms may involve the additional problem of conforming the preworded auditor's opinion or certificate to professional standards. Many of these forms are not acceptable to the independent certified public accountant because the desire for uniform financial presentation conflicts with fair presentation in the particular case, or the printed language of the auditor's opinion or certificate calls for asser-

tions by him that are not part of his functions and responsibilities as an independent certified public accountant. Some forms can be made acceptable by typing in additional captions or wording; others can be made acceptable only by complete revision. Whenever the printed forms call upon the auditor to make an assertion which he believes he is not justified in making, he generally has no alternative but to reword them or to submit his separately typed report.

Securities Brokers and Dealers

The Securities and Exchange Commission requires certain securities brokers and dealers to file audited reports annually with the Commission.

Rule 17A-5 of General Rules and Regulations under the Securities and Exchange Act of 1934 requires that every member of a national securities exchange who transacts a business in securities directly with or for others than members of a national securities exchange, and every broker or dealer (other than a member) who transacts a business in securities through the medium of any member, and every broker or dealer registered under the Securities Exchange Act of 1934 shall file on Form X-17A-5, during each calendar year, a report on his financial condition. This report must be certified by an independent certified public accountant or public accountant unless one of three very limited exemptions from the requirement applies.

The New York Stock Exchange has, since 1939, required many of its members to have annual audits by independent public accountants in conjunction with their answers to questionnaires submitted to the Exchange. The Exchange has required audits since 1924 but had not previously stipulated that they be made by independent certified public accountants. Effective February 1, 1940, the Committee on Member Firms adopted a ruling relating to audits under the provisions of Rule 417 of the Board of Governors. Under this ruling each member firm doing any business with others than members and member firms is required to have an annual audit of its affairs. The audit must be conducted in accordance with the committee's audit regulations by independent public accountants at a date to be selected by the accountants without prior notice to the member firm, and the accountants must prepare the answer to a financial questionnaire of the committee upon the basis of their audit. Each year the member firm selects an accountant, who makes a "surprise" audit and notifies the Department of Member Firms when he has commenced the audit. Notice of the selection of the independent certified public accountant must be made to the Department of Member Firms by

January 10th of each year. The accountant submits the member's answer to the financial questionnaire directly to the Department of Member Firms and furnishes that committee with a copy of his audit report.

With a view to devising a standard form of questionnaire for use by or acceptable to all regulatory bodies, discussions were entered into in 1942 by the staffs of the Securities and Exchange Commission and the national securities exchanges. Committees of the American Institute of Certified Public Accountants and of the National Association of Securities Commissioners also participated.

At this time the financial questionnaire of the New York Stock Exchange was amended. The General Instructions, Parts I and II of the questionnaire, and the audit regulations became identical with Form X-17A-5 of the Securities and Exchange Commission. Part III of the Exchange questionnaire was added to provide for information not covered in Parts I and II.¹

Because of this collaboration and the uniformity in audit and reporting requirements thus achieved, a dealer who is required to file with the Securities and Exchange Commission on Form X-17A-5 may, in lieu thereof, file a copy of any financial statement which he is required to file with any national securities exchange of which he is a member, or with any agency of any state as a condition of doing business in securities in that state, provided it presents his financial condition at a date not more than forty-five days prior to filing with the Commission and meets the requirements of the rule and contains the information required by Form X-17A-5.

The New York Stock Exchange requires under Rule 418 that the independent certified public accountant shall attest, in a written report addressed to the member firm, that the requirements of the audit regulations have been observed in the conduct of the audit and shall specifically comment that he has reviewed the methods of internal accounting control and the procedures for safeguarding securities.

Rule 17A-5 requires that the accountant's certificate shall:

- (a) contain a reasonably comprehensive statement as to the scope of the audit made, including a statement as to whether the accountant reviewed the procedures followed for safeguarding the securities of customers, and including, if with respect to significant

¹ George A. Cuff, *Supervision of the Financial Condition of New York Stock Exchange Member Firms*, American Institute of CPAs' 1950 Annual Meeting Papers.

items in the report covered by the certificate any auditing procedures generally recognized as normal have been omitted, a specific designation of such procedures and of the reasons for their omission;

- (b) state whether the audit was made in accordance with generally accepted auditing standards applicable in the circumstances;
- (c) state whether the audit made omitted any procedure deemed necessary by the accountant under the circumstances of the particular case;
- (d) state clearly the opinion of the accountant with respect to the financial statement covered by the certificate and the accounting principles and practices reflected therein;
- (e) identify clearly any matters to which the accountant takes exception, and state the exception specifically and clearly, and, to the extent practicable, the effect of each such exception on the related item of the report.

In 1956, the American Institute of Certified Public Accountants published the booklet *Audits of Brokers or Dealers in Securities*, as a guide in determining the scope of work in each individual audit and to assist the independent certified public accountant to an expression of an informed opinion on the financial statements of a broker or dealer in securities or commodities.

The following adaptations of the standard short-form report are suitable:

1. For use with published financial statements:

We have examined the statement of financial condition of _____ as of _____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included *a review of the system of internal control and the procedures for safeguarding securities and** such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

*The language in italics, or similar language, is required in reports to jurisdictional agencies but is optional for other reports, such as those submitted to customers of the brokerage concern. The Institute has recommended to the jurisdictional agencies that it be deleted to conform with the scope paragraph of the standard short-form of report.

In our opinion, the accompanying statement of financial condition presents fairly the financial position of _____ at _____, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.**

2. To accompany answers to the Securities and Exchange Commission or New York Stock Exchange questionnaire:

We have examined the Answers to the Financial Questionnaire of _____ as of _____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included *a review of the system of internal control and the procedures for safeguarding securities and** such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances *including the audit procedures prescribed by the (jurisdictional agency).**

In our opinion, the accompanying Answers to the Financial Questionnaire present fairly the financial position of _____ at _____, in the form required by the (jurisdictional agency), in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.**

Highway Contractors' Prequalification Reports

State highway departments generally require that contractors who wish to bid on road construction projects qualify in advance by filing satisfactory financial statements. After the original filing the contractor must file periodically if he wishes to be at all times eligible to bid.

The purpose of prequalification is to eliminate from consideration those contractors who are without adequate financial responsibility to perform the contract, and to insure the concurrent benefits of protecting the state from construction tie-ups, the suppliers from bad-debt losses, and the contractors from financial disaster through over-expansion.

The standards by which the commissions determine eligibility vary among the states. The net working capital, the borrowing capacity, and the adequacy of the contractor's equipment are among the factors considered, in varying ratios, in different jurisdictions.

**To avoid confusion, the word "year" may be used even though the current examination is being made as of a date more or less than twelve months after the date of the previous examination.

The form and content of the material which the contractor must file also vary among the states, although several have adopted a fairly uniform outline of balance sheet and detailed schedules. A few commissions prescribe the audit program as well, and require an assertion by the independent auditor that he performed the audit in accordance with this program. Most of the commissions prescribe the wording of the independent auditor's certificate. At least one has adopted the standard short-form report.

Generally, however, the wording of the printed form of certificate is such as to require assertions from the independent auditor which are outside the field of his functions and responsibilities. Mostly these certificates are worded as statements of fact rather than opinion. They do not mention auditing standards or generally accepted accounting principles. Some contain inaccurate or ambiguous phraseology. They tend to include such expressions as "correctly reflect" and "has been fully verified and found to be correct." In one, the independent auditor is asked to state that he has "taken an inventory of both the assets and liabilities." One contains words which might be construed as implying an appraisal of assets, a function which the independent certified public accountant's training and experience do not qualify him to perform. In short, the printed certificates generally do not describe correctly the service which the independent auditor renders, nor do they adhere to the standards set up by the profession for the short-form report.

In many instances independent auditors have disregarded the printed form of certificate and have filed in its stead the standard short-form report, modified, where necessary, to relate it to the balance sheet only. Whenever the printed form provided by state highway commissions does not conform in its essentials to the standard short-form report, the use of a separately typed opinion which does conform to those standards is advisable.

Appraisals. When contractors use appraised values for equipment or other assets, the treatment of appraisals in the accounts and in the financial statements should conform to generally accepted principles of accounting and generally accepted standards of reporting.

Partnerships and Sole Proprietorships. When the contractors are partnerships or sole proprietorships the standards enunciated in this pamphlet under those respective headings apply, in addition to those contained in this section.

Cash Basis. Reference should be made to the section on cash basis statements for additional standards which apply where the accounts are kept on a cash basis, pages 9 to 17.

Examples of Reports. The highway commission in one state has adopted a nineteen-page form which includes balance sheet, schedules, certified public accountant's opinion, and contractor's affidavits. Among the regulations are these three of special interest to the independent certified public accountant:

- (4) . . . no substitute form will be accepted.
- (5) The opinion of the certified public accountant must be unqualified.
- (6) Additional information, including explanatory notes considered necessary, may be furnished by inserting schedules where needed. . . .

The form prescribed for the accountant's opinion conforms to the standard short-form report and reads as follows:

Certified Public Accountant's Opinion

We have examined the financial statement of X Corporation as of September 30, 19____ and the related schedules contained on pages ____ through _____. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying financial statement and related schedules contained on pages ____ through ____ present fairly the financial position of X Corporation at September 30, 19____, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Firm _____
By _____
Certified Public Accountants
Address _____

The form provides no specific line for a date, but the opinion should be dated by the independent auditor, since the date may have an important bearing upon his responsibility.

This form, separately typed, has also been used in the same state:

We have examined the balance sheet of X Corporation as of September 30, 19____, the related statements of net earnings and accumulated earnings retained in the business for the year then ended, and the related schedules contained on pages 3 to 13 of the (*state highway commission*) statement of experience and financial condition. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying balance sheet presents fairly the financial position of X Corporation at September 30, 19____, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year. Further, it is our opinion that the schedules previously referred to present fairly the information set forth therein.

(Firm Signature)

Certified Public Accountants

_____, 19____.

AFFIDAVIT

State of _____)
County of _____) ss

The undersigned, _____, being duly sworn, deposes and says that he is a general partner of the firm of _____ and that he signed the foregoing opinion for said firm; and further, that all partners of said firm practicing in the State of _____ hold unrevoked certificates as certified public accountants in said State and by virtue thereof the firm is qualified to practice therein as certified public accountants in accordance with the laws of such State regulating such practice.

(Partner's signature)

Sworn to before me this

_____ day of

_____, 19____.

Notary Public

Below is an example of an opinion, separately typed and attached to the printed form, in which mention is made of conformance with an audit program published by another state highway department

(reference to examination of the income statement as part of the examination is optional):

We have examined the balance sheet of X Corporation as of September 30, 19____, and the related statements of net earnings and earnings retained for use in the business for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances. The examination also complied with the Instructions to Certified Public Accountants contained in Bulletin _____, published by the _____ State Highway Department.

In our opinion, the accompanying balance sheet presents fairly the financial position of X Company at September 30, 19____, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

Reference to the schedules, if required, would be made in the manner illustrated in the first example given.

Below is an example of a separately typed opinion in which operations and construction costs are covered:

We have examined the statement of financial condition of X Corporation as of September 30, 19____, and the related statements of operations and of construction costs for the year then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the accompanying statement of financial condition and statement of operations and of construction costs present fairly the financial position of X Corporation at September 30, 19____, and the results of its operations and its construction costs for the year then ended, in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The following illustrates a disclaimer which was accepted by the commission with which it was filed (the printed form of certificate was in the form of an affidavit):

State of _____)
County of _____) ss

XYZ being duly sworn, deposes and says:

That he is a certified public accountant of the State of _____ and that he has examined the financial statements of X Company at the close of business September 30, 19____. His examination consisted primarily of a review and study of the accounts and other data supporting the statement of financial position at the year-end and the related statement of income and surplus. The extent of his examination was not sufficient for him to express an opinion on the representations made in the attached statement. However, nothing came to his attention during the examination which would indicate that these items are not stated fairly.

Sworn to before me this _____ Certified Public Accountant
day of _____, 19____

Notary Public

Massachusetts Certificate of Condition

The Commonwealth of Massachusetts requires business corporations doing business within its borders, with certain exceptions, to file annually with the Commissioner of Corporations and Taxation a Certificate of Condition. If the certificate is approved by the Commissioner it is filed in the office of the state secretary, where those who deal with the corporation may consult it to learn the corporation's financial condition.

Corporations with issued capital stock of one hundred thousand dollars or more (for this purpose shares without par value are counted as of a par value of one hundred dollars each) must file a written statement on oath by "a duly selected and employed auditor" that the report represents "the true condition of the affairs of said corporation as disclosed by its books at the close of the fiscal year covered by such report." The statute specifies the method of appointing the auditor and requires that he be "duly sworn to the faithful performance of his duties."

The report is filed on a printed form which includes wording for both the balance sheet and the auditor's certificate.

The printed form for the auditor's certificate relating to Massachusetts corporations reads as follows:

Auditor's Certificate

_____, 19____
In Compliance with General Laws, Chapter 156, Section 49,
I, _____ the duly selected and employed auditor
of _____ hereby state under the penalties of
perjury that the foregoing report represents the true condition
of the affairs of said corporation as disclosed by its books at the
close of the fiscal year covered by such report.

Auditors

When a firm of independent auditors signs the statement the Commissioner requires that both the firm signature and the signature of the person authorized to sign for the firm be used.

The form for foreign corporations is substantially the same as for domestic corporations, except for the introductory phrase, which reads, "In compliance with the provisions of Massachusetts General Laws, Chapter 181, Section 13, I, _____, the duly chosen auditor of . . ."

These forms contain no description of the work performed and no words which characterize the "certificate" as an opinion. The significance of "as disclosed by its books" is not clear, but the words "hereby state under the penalties of perjury that the foregoing reports represent the true condition of affairs" contain an assertion which an independent auditor is in no position to make. The profession is in agreement that "management is primarily responsible for the accuracy of the financial statements and that the auditor can only express his opinion on them."² The Securities and Exchange Commission has said, "... accountants may not be able to certify as to the correctness of the figures appearing on the financial statements in the sense of guaranteeing or warranting their correctness but can merely express their opinion with respect to them . . ."³

The printed form provided for the balance sheet is adequate for many companies. For others it is sometimes so inappropriate that a separate balance sheet must be typed and attached to the form. A completely different category of assets or liabilities, special items, necessary differentiations, and important footnotes are among the matters which may require that superseding or additional material be attached.

As the printed form of certificate has no place for qualifications,

² *Codification of Statements on Auditing Procedure*, page 15.

³ 4 SEC 721 (1939).

Some independent auditors regularly type separate balance sheets and certificates and attach them to the form. Others follow this procedure in some instances and adhere to the printed form in others, modifying the certificate by inserting the words “in my (our) opinion” and adding any specific qualifications.

The printed form of certificate is in general not appropriate, and the use of a separate opinion which, in addition, conforms in all essentials to the wording of the standard short-form report is recommended. Obviously a balance sheet whose essential features cannot be expressed in the printed form must be typed separately and copies attached in each of the two places provided on the form. The questions which, on the printed form, follow the balance sheet should be answered, either by typing the answers on the form or by typing both questions and answers on the separate balance sheet.

The form of independent auditor's "verification" provided in this report is generally considered unsuitable for reasons very similar to those which make the one provided in the Massachusetts Certificate of Condition objectionable. The following adaptation, provided as an insert, is recommended:

The undersigned, (*firm name*), represent that they are independently engaged in the practice of public accounting at (*address*) and that they have made an independent examination of the financial statements of (*organization*) for the fiscal year ended (*date*), in accordance with generally accepted auditing standards, which accordingly included such tests of the accounting records and such other auditing procedures as they considered necessary in the circumstances.

The information contained in Section B, pages 2 and 3 of this report, was reviewed on the basis of such examination and, in the opinion of the undersigned, presents fairly the receipts and expenditures of (*organization*) for the year ended (*date*) in the form required by the department.

(Date) _____ Name (Firm name)
 (signature)

Title (Partner's signature), Partner

United States Department of Labor Reports

Welfare and Pensions Plans. The Welfare and Pension Plans Disclosure Act requires that an annual report must be filed with the U.S. Labor Department. The Act specifies the information to be included and provides that it "shall be sworn to by the administrator, or certified to by an independent certified or licensed public accountant, based upon a comprehensive audit conducted in accordance with accepted standards of auditing." The reports, for plans keeping their records on a calendar-year basis, should be received by the Labor Department within 120 days after December 31.

The Secretary of Labor has made available Form D-2, Employee Welfare or Pension Benefit Plan Annual Report Form, to assist administrators in discharging their responsibilities for filing annual reports under the Act. However, use of Form D-2 is optional with the administrator of the plan.

Included among the information required under the Act are "a summary statement of assets, liabilities, receipts and disbursements of the plan; a detailed statement of the salaries and fees and commissions charged to the plan, to whom paid, in what amount, and for what purposes." This kind of information would, of course, be covered in the ordinary examination performed by an independent auditor and he could appropriately express an opinion regarding it. However, other information required by the Act would usually be obtained from the fund's records without audit or would be supplied on the basis of reports submitted by other organizations (mostly insurance companies) to the fund. Accordingly, the problem is to word the audit report in such a way as to make clear the parts of the fund's annual report to which the independent auditor's opinion relates.

An example of language which might appropriately be used in independent auditors' reports accompanying Form D-2 is given below.

We have examined the statement of assets and liabilities and supporting schedules of ABC Fund as at December 31, 19___ and the related statement of operations and fund balances for the period then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

In our opinion, the statement of assets and liabilities, Exhibit

B-1, and the summary of operations and fund balances and supporting schedules contained in Exhibit B-2 and Schedules 1 and 2 of the accompanying annual report present fairly the financial position of ABC Fund at December 31, 19__ and the results of its operations for the year then ended in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year.

The information contained in Parts I, II and III and Exhibits A-1, A-2, A-3 and C of the accompanying annual report has been obtained from the records of ABC Fund or has been received directly from the respective insurance companies and actuaries. Such information has not been subject to examination by us and accordingly we can accept no responsibility as to its accuracy.

Labor Organization Financial Reports. The Labor-Management Reporting and Disclosure Act of 1959 requires each labor organization subject to its provisions to file annually a financial report with the Secretary of Labor. The Secretary, as authorized by the Act, has prescribed two Labor Organization Financial Reports, Forms LM-2 and LM-3.

Form LM-2 must be filed by every labor organization engaged in an industry affecting commerce except those labor organizations which are authorized to and do file a simplified report on Form LM-3. A labor organization with gross annual receipts of less than \$20,000 may, when not in trusteeship, file the simplified financial report Form LM-3 if, because of its size, furnishing a detailed report would substantially increase its operating costs or the burdens of its officers who hold other regular jobs. The term "gross annual receipts" means the total of all financial receipts of the organization during its fiscal year, irrespective of source and without any exclusions or deductions of any kind, and regardless of whether received directly by the reporting organization or by some person or persons acting on its behalf.

The two financial statements prescribed in the reporting forms are: (1) a statement of assets and liabilities, prepared on substantially an accrual basis and, (2) a statement of receipts and disbursements, which reflects cash transactions only and provides a reconciliation between the opening and closing cash balances. There is no provision for the inclusion of a statement of income in the prescribed report.

The Act does not require that the prescribed forms, when filed, must be accompanied by an independent auditor's report. However, since the AFL-CIO Code of Ethical Practices with respect to financial

practices of unions requires annual audits of all affiliates by certified public accountants, there may be instances in which independent auditors may be requested to render, in addition to a report on the regular examination, an opinion on these prescribed financial statements. In such cases, it is apparent that a problem exists as to appropriate wording.

An example of the language independent auditors might appropriately use in such reports is given below.

We have examined the statement of assets and liabilities and supporting schedules of _____ as of June 30, 19__ and the statement of receipts and disbursements for the period then ended. Our examination was made in accordance with generally accepted auditing standards, and accordingly, included such tests of the accounting records and such other auditing procedures as we considered necessary in the circumstances.

Net assets as shown on line 18, in the statement of assets and liabilities, increased (decreased) \$_____ during the year. This increase (decrease) is represented by a net income (loss) from operations of \$ _____ and (description of any other charges or additions made during the year to balance of fund [surplus] account).

(In most cases it will probably be necessary to indicate the specific fund balances and the net changes in each such fund balance comprising the total net assets figure, to provide adequate disclosure and presentation of financial position.)

In our opinion, the accompanying financial statements and related schedules present fairly the financial position of _____ at June 30, 19__ in conformity with generally accepted accounting principles applied on a basis consistent with that of the preceding year and the cash transactions for the year then ended.

Form LM-2, in addition to the two previously described financial statements, prescribes various detailed reporting schedules.

It is believed that, in general, it will be possible for the independent auditor to satisfy himself as to the fairness of the information required in the schedules as a result of his regular examination. However, where this is not the case, similar wording to that used in the last paragraph of the example shown on page 97, Welfare and Pension Plans, would be appropriate.

APPENDIX

Statements on Auditing Procedure No. 28

October 1957

Special Reports

(Applicability of Reporting Standards in Special Circumstances)

Introduction

1. The independent certified public accountant has long had authoritative literature and accepted practice to guide him in that part of his work which has to do with reporting on the more usual types of financial statements of corporate business enterprises organized for profit. When he has undertaken to report on matters outside that category, he has had little besides his own experience and judgment to guide him, since the profession has not clarified the applicability of generally accepted auditing standards in such circumstances.

2. The purposes of this statement are:

- a. To provide a basis for differentiating between reports for which the wording of the usual short-form opinion or certificate (whether used in a short-form or long-form report) is appropriate and reports for which special wording in the opinion or certificate seems to be necessary. These latter reports are generally referred to hereinafter as "special reports."
- b. To clarify the applicability of generally accepted auditing standards to such special reports.

Types of Special Reporting Circumstances

3. Special reports (see Paragraph 2a) may include:

- a. Reports on financial statements of organizations which main-

tain their accounts and prepare their statements on a cash or other incomplete basis of accounting which is materially at variance with accounting practices customarily followed in preparing accrual basis statements. These organizations may include some organized for profit, particularly those carried on by individuals and partnerships, as well as some nonprofit organizations.

- b. Reports on financial statements of some nonprofit organizations which follow accounting practices differing in some respects from those followed by business enterprises organized for profit. These organizations may include municipalities, hospitals, cooperatives, and educational institutions.
- c. Reports prepared for limited purposes, such as:
 - (1) Reports that relate only to certain aspects of financial statements. These reports may include reports, sometimes in letter form, relating to special studies, to compliance with certain provisions of bond indentures, or to the determination of the amounts of rentals, royalties, profit-sharing bonuses and the like.
 - (2) Reports that are filed with various agencies on prescribed forms which provide a uniform statement presentation, in some cases with a preworded opinion or authentication. These reports may include reports prepared for filing with various governmental authorities or with credit and similar agencies.

4. Compliance by financial institutions, insurance companies, railroads, and the like, with accounting practices prescribed by a regulatory authority may create reporting problems; however, the committee, for the present, is not dealing with the usual reports on financial statements of regulated companies and this statement is not intended to apply to them or to alter any previous pronouncements applicable to them. Nor is this statement intended to apply to reporting problems relating to tax returns or to management service reports.

Applicability of Generally Accepted Auditing Standards

5. The wording of the usual short-form opinion or certificate on examination of financial statements (whether included in a short-form or long-form report) is designed for an expression of opinion on the fairness with which such statements present financial position and re-

sults of operations. While no precise definition of the term financial statements has been made by the committee, it is quite clear that the term as used in the pamphlet *Generally Accepted Auditing Standards*, as well as in Statement on Auditing Procedure No. 27, *Long-Form Reports*, refers to financial statements which purport to show financial position and results of operations; such financial statements usually consist of a balance sheet and statements of income, retained earnings, and capital.

6. *Generally Accepted Auditing Standards* characterizes the term "generally accepted auditing standards" as used in auditors' reports on financial statements in such a way as to include (a) general standards, (b) standards of field work, and (c) standards of reporting. It is the opinion of the committee that, to the extent appropriate in view of the character of the engagement, the substance of the general standards and of the standards of field work applies to engagements involving special reports.

7. The four standards of reporting require (1) an opinion as to conformity of financial statements with generally accepted principles of accounting, (2) an opinion as to the consistency with which these principles have been observed, (3) adequate informative disclosures, and (4) an expression of opinion regarding the financial statements taken as a whole, or a statement to the effect that an opinion cannot be expressed, together with the reasons therefor, and, in all cases, a clear-cut indication of the character of the auditor's examination, if any, and of the degree of responsibility he is taking.

8. Although there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations, such as in reports upon compliance with certain provisions of bond indentures, the committee is of the opinion that the requirement of the first standard of reporting does not apply to statements which do not purport to set forth financial position and results of operations. Statements prepared on the basis of cash receipts and disbursements, for example, usually do not purport to present financial position or results of operations. In reporting on statements which do not so purport the auditor should make sure that it is clearly stated what they do purport to present and the basis on which they have been prepared. He should express his opinion as to whether or not the statements fairly present the data on the basis indicated. The committee believes it to be generally prefer-

able in these circumstances to avoid the use of the terms "balance sheet," "income statement," or similar titles with respect to such statements; notwithstanding this preference, the committee recognizes the long-established acceptance of these terms and accordingly feels that it should not, at this time, do more than express its preference.

9. In reporting on statements prepared on a cash basis (or substantially so) which nevertheless may appear to present financial position and results of operations, disclosure should ordinarily be made in the statements or their footnotes or, less preferably, in the auditor's report, (a) of the fact that the statements have been prepared on the basis of cash receipts and disbursements and (b) of the general nature of any material items omitted (such as accounts receivable and accounts payable) and, where practicable, of the net effect of such omissions on the statements. The auditor's opinion might then be worded somewhat as follows:

In our opinion, the accompanying statements present fairly the assets and liabilities of the XYZ Company, at December 31, 19____, arising from cash transactions, and the revenues collected and expenses disbursed by it (and changes in proprietary interest, fund balances, etc., where reflected in cash basis statements) during the year then ended, on a basis consistent with that of the preceding year.

Notwithstanding the foregoing, where the auditor thinks that misleading inferences may still be drawn from the statements, he should include an explanation in his report that the statements do not present financial position and results of operations.

10. In reporting on statements prepared on a modified accrual basis of accounting, which nevertheless usually purport to present financial position and results of operations, the auditor may consider the resulting statements to be materially incomplete or to have been prepared in accordance with accounting practices materially at variance with those customarily followed in preparing accrual basis statements. In such cases it is desirable to disclose the nature and amounts of the major items involved and, in his report, to state an exception or explain clearly why he is unable to express the usual opinion on the fairness of presentation of financial position and results of operations.

11. If the statements are those of a nonprofit organization they may reflect accounting practices differing in some respects from those followed by business enterprises organized for profit. It is recognized

that in many cases generally accepted accounting principles applicable to nonprofit organizations have not been as clearly defined as have those applicable to business enterprises organized for profit. In those areas where the auditor believes generally accepted accounting principles have been clearly defined (as indicated by authoritative literature and accepted practice, etc.) he may state his opinion as to the conformity of the financial statements either with generally accepted accounting principles, or (alternatively, but less desirably) with accounting practices for nonprofit organizations in the particular field (e.g., hospitals, educational institutions, etc.), and in such circumstances he may refer to financial position and results of operations; in either event, it is assumed that the auditor is satisfied that the application of such accounting principles and practices results in a fair presentation of financial position and results of operations or that he will state his exceptions thereto. In those areas where the auditor believes generally accepted accounting principles have not been clearly defined, the other provisions of this statement apply.

12. When the report relates to statements which purport to present financial position or results of operations, the second standard of reporting as to consistency in the application of generally accepted accounting principles is, of course, applicable. When the report relates to other matters, reference to consistency is frequently appropriate, depending upon the nature of the matter reported upon.

13. As to the third standard of reporting, adequate informative disclosures are, of course, required at all times. Where the auditor considers the basis on which the financial statements have been prepared to be inappropriate or unsuitable in the circumstances, appropriate disclosures should be made.

14. The fourth standard of reporting requires that the report shall contain either an expression of opinion, or an assertion to the effect that an opinion cannot be expressed and the reasons therefor. This standard also requires that the report should contain a clear-cut indication of the character of the auditor's examination, if any, and the degree of responsibility he is taking. At the time this standard was adopted the major concern was with statements purporting to show financial position or results of operations. The requirements of this auditing standard, however, are, in the committee's opinion, applicable to special reports.

Other Aspects

15. Special reports in which incomplete financial presentations or no financial presentations are made (e.g., calculations of royalties, profit-sharing bonuses, rentals, etc.) should be drafted with a view to their special purpose and, accordingly, should state what information is presented, the basis on which it was prepared, and whether, in the auditor's opinion, it is presented fairly on that basis. As indicated in Paragraph 8, there may be occasions when it is appropriate for the auditor to report upon conformity with generally accepted accounting principles of incomplete financial presentations; such occasions usually arise when there is interest in establishing that a part only of the financial statements is in conformity with generally accepted accounting principles, such as the determination of "working capital" under a bond indenture. There may be occasions, in reports containing an expression of an opinion on the fairness with which financial statements present financial position and results of operations, where the auditor also expresses an opinion as to the adequacy or reasonableness of specific accounts, such as those for the allowance for doubtful accounts receivable or the liability for income taxes. The usual examination of financial statements is designed for the purpose of formulating an opinion with respect to financial statements taken as a whole and not necessarily with respect to specific accounts. Accordingly, it is generally undesirable for an auditor to render a separate opinion on a specific account, but where the situation is such that he considers it appropriate to do so, he should be cognizant of the added responsibility he may thereby be assuming and the possible necessity of extending the scope of his examination.

16. Statements prepared on printed forms designed by the authorities with which they are to be filed may require inappropriate classifications or other similar procedures that, in the auditor's opinion, do not fairly present the financial position or results of operations of the particular company filing the statements, even though they purport to do so. Also, such forms may involve the additional problem of conforming the preworded auditor's opinion or certificate to professional standards. Many of these forms are not acceptable to the independent certified public accountant because the desire for uniform financial presentation conflicts with fair presentation in the particular case, or the printed language of the auditor's opinion or certificate calls for assertions by him that are not part of his functions and responsibilities as an independent certified public accountant. Some forms

can be made acceptable by typing in additional captions or wording; others can be made acceptable only by complete revision. Whenever the printed forms call upon the auditor to make an assertion which he believes he is not justified in making, he generally has no alternative but to reword them or to submit his separately typed report.

The statement entitled "Special Reports (Applicability of Reporting Standards in Special Circumstances)" was adopted unanimously by the twenty-one members of the committee, of whom one, Mr. Sprague, assented with qualification.

Mr. Sprague qualifies his assent because he believes the reporting problems referred to in Paragraph 4 should have been outlined for clarification and that the statement should have included a discussion of the manner in which the auditor's opinion can meet the requirements of existing standards of reporting and also deal with the requirements of regulatory bodies.

Committee on Auditing Procedure (1956-1957)

HORACE G. BARDEN, *Chairman*

M. M. DEVORE

EARL W. HAMMILL

JOHN H. HANSON, JR.

THOMAS L. HOLTON, JR.

R. A. LILE

JOHN C. MARTIN

JESSE W. MASSEY, JR.

C. R. MILLER

MEL D. MOERSH

JOHN C. POTTER

HAROLD M. SOLSTAD

W. D. SPRAGUE

CHARLES A. STEWART

JOHN M. STOEY

JOSEPH F. SULLIVAN

EDWARD P. TREMPER

J. CARLTON UPDIKE

I. T. WELLING, JR.

B. A. WILSON

CHARLES A. ZARINI

CARMAN G. BLOUGH,

Director of Research

INDEX

Appraisals (see Reports, prescribed form)		
Auditor, independent		
independence (see also Churches, community funds, and other religious, charitable, or cultural organizations)		
Bond indentures (see Reports, special aspects)		
Cash and other incomplete accounting basis,		
applicability of reporting standards	8	
description	8	
(see also Cash basis statements)		
Cash basis statements,		
description	11	
example reports	14	
footnotes, disclosing omissions by	12	
generally accepted accounting principles, reference to	12	
titles, descriptive	13	
uses and limitations	12	
(see also Churches, community funds, and other religious, charitable, or cultural organizations, Clubs, Colleges and Universities, Estates, trusts and guardianships, Farms, Hospitals, Municipalities, Partnerships, Personal Accounts, Reports, prescribed form, Proprietorships, sole)		
Churches (see Churches, community funds, and other religious, charitable, or cultural organizations)		
Churches, community funds, and other religious, charitable, or cultural organizations,		
depreciation	33	
example reports	33	
income from voluntary contributions	32	
independence of independent auditor	33	
pledges	32	
property	33	
Clubs,		
description	37	
example reports	38	
Colleges and Universities,		
accrual basis, modified	44	
applicability or reporting standards	45	
depreciation	43	
description	42	
loans, construction, repayment of	45	
reporting procedures—		
accrual basis	46	
cash basis	46	
example reports	46	
securities, profit and losses on sale of	44	
Community funds (see Churches, community funds and other religious, charitable or cultural organizations)		
Contract guarantees (see Reports, special aspects)		
Crops, unharvested (see Farms)		
Depreciation (see Churches, community funds and other religious, charitable or cultural organizations, Colleges and Universities, Farms, Hospitals, Municipalities)		
Estates, trusts and guardianships,		
description	26	
example reports	26	
Farms,		
crops, unharvested	30	
depreciation	30	
description	29	
example reports	31	
income taxes	30	
produce and livestock	30	
salaries of proprietors	30	
Field standards (see Generally accepted auditing standards)		
Footnotes (see Cash basis statements)		
General standards (see Generally accepted auditing standards)		

Generally accepted auditing standards, field standards—		New York Stock Exchange (see Reports, prescribed form)	
applicability	8	Nonprofit organizations, special accounting practices, which follow	41
general standards—		(see also Churches, community funds and other Religious, charitable or cultural organizations, Colleges and Universities, Hospitals, Municipalities, Clubs)	
applicability	8	Partnerships,	
reporting standards—		description	21
applicability	9	example reports	22
(see also Cash basis statements, Non-profit organizations which follow special accounting practices, Reports, special aspects, Reports, prescribed form)		income taxes	21
Highway contractors,		personal assets and liabilities	22
prequalification reports (see Reports, prescribed form)		salaries of partners	22
Hospitals,		(see also Reports, prescribed forms)	
accrual basis, recommended	56	Pension and profit-sharing plans (see Reports, special aspects)	
depreciation	56	Personal Accounts, description	24
description	55	example reports	24
reporting procedures—		(see also Proprietorships—sole, Partnerships)	
accrual basis	57	Pledges (see Churches, community funds and other religious, charitable or cultural organizations)	
cash basis	57	Produce and livestock (see Farms)	
example reports	57	Property (see Churches, community funds and other religious, charitable or cultural organizations)	
Income,		Proprietorship—sole,	
available for dividends (see Reports, special aspects)		description	17
voluntary contributions, from (see Churches, community funds, and other religious, charitable and cultural organizations)		example reports	19
Income taxes (see Proprietorships—sole, Partnerships, Farms)		income taxes	18
Labor organizations,		personal assets and liabilities	17
financial reports—		salary of proprietor	18
United States Department of Labor (see Reports, prescribed form)		writing up of records	18
Lease agreements		(see also Reports, prescribed form)	
(see Reports, special aspects)		Reporting standards (see Generally accepted auditing standards)	
Loans (see Colleges and Universities and Reports, special aspects)		Reports, prescribed form,	
Massachusetts certificate of condition (see Reports, prescribed form)		description	85
Municipalities,		reporting standards, applicability	85
accrual basis	50	reports on—highway contractors, pre-qualification,	
accrual basis, modified	50	appraisals	90
depreciation	50	cash basis	91
description	49	description	89
reporting procedure, on—		example reports	91
accrual basis	51	partnerships	90
cash basis	51	proprietorships—sole	90
example reports	51	massachusetts certificate of condition,	
New York State Welfare Department, annual report on charitable organizations (see Reports, prescribed form)		description	94
		reporting procedure	95

new york state welfare department, annual report on charitable or- ganizations	96	example reports	67
securities brokers and dealers, example reports	88	special aspect examinations, various, example reports,	
regulations—		Contract guarantees	83
securities and exchange commis- sion	86	Income available for dividends	82
new york stock exchange	86	Lease agreements	80
united states department of labor, labor organizations, financial	98	Pension and profit sharing plans	75
welfare and pension plans	97	Royalty agreements	73
Reports, special aspects, description	61	Sinking fund contributions	81
reporting standards, applicability	61	Sole proprietorships (see Proprietor- ships—sole)	
reports, on—		Statements on auditing procedures, No. 28	Appendix
bond and loan agreements, compli- ance with, description	62	Underwriters (see Reports, special as- pects)	
example reports	63	United States Department of Labor (see Reports, prescribed form)	
underwriter information letters, description	66	Welfare and pension plans (see Re- ports, prescribed form)	
		Writing up of records (see Proprietor- ships—sole)	